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In The

Supreme Court of the United States

UNITED STATES OF AMERICA,
ex rel. ROBERT PRITSKER,

Petitioner,

v.

SODEXHO, INC., SODEXHO AMERICA, LLC,
SODEXHO MARRIOTT MANAGEMENT, INC.,
SODEXHO MANAGEMENT, INC.,
ARAMARK CORPORATION, AND
ARAMARK EDUCATIONAL SERVICES, INC.,

Respondents.

On Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Third Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

For purposes of the False Claims Act's "public disclosure" bar, has the identity of a *qui tam* defendant already been publicly disclosed (with the *qui tam* action consequently barred) where the relevant government reports had not named or otherwise specifically identified any Respondent industry member as a wrongdoer, and where the reports had disclosed fraud in only part of Respondents' industry?

PARTIES TO THE PROCEEDING

Pursuant to Rule 14.1(b), the following identifies all of the parties appearing here and before the United States Court of Appeals for the Third Circuit:

Robert Pritsker, the *qui tam* relator, is the Petitioner here and was the plaintiff-appellant below.

Sodexho, Inc., Sodexho America, LLC, Sodexho Marriott Management, Inc., and Sodexho Management, Inc. (collectively, "Sodexho") and Aramark Corporation and Aramark Educational Services, Inc. (collectively, "Aramark") are the Respondents here and were defendants-appellees below.

Compass Group USA, Inc., d/b/a Chartwells ("Chartwells") was a defendant-appellee below but is not a Respondent here.

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JURISDICTION

The Court of Appeals entered judgment on February 9, 2010. On February 23, 2010, Petitioner filed a petition for panel rehearing and rehearing en banc. The Court of Appeals denied the petition on March 16, 2010. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTES AND RULES INVOLVED

1. 31 U.S.C. § 3730(e)(4)(A):

> No court shall have jurisdiction over an action under this section based upon the public disclosure of allegations or transactions in a criminal, civil, or administrative hearing, in

> a congressional, administrative, or Government[1] Accounting Office report, hearing, audit, or investigation, or from the news media, unless the action is brought by the Attorney General or the person bringing the action is an original source of the information.

STATEMENT OF THE CASE

A. Introduction: The Circuit Split

Under the public disclosure bar of the False Claims Act ("FCA"), 31 U.S.C. §§ 3729 *et seq.*, an action brought pursuant to the FCA's *qui tam* provisions must be dismissed if the action is "based upon the public disclosure of allegations or transactions" in a statutorily listed source ("statutory source"), such as a news article or a government audit report. *See* 31 U.S.C. § 3730(e)(4)(A). The circuits have divided over the test for determining whether there has been a "public disclosure" of an essential element of such "allegations or transactions," namely, a *qui tam* defendant's identity: Was the defendant "specifically identified" in the statutory source, or, alternatively, was the defendant "easily identifiable"? More specifically, the circuits have divided over whether the "easily identifiable" test applies only in cases where a statutory source has disclosed *universal* fraud within

[1] The United States Code Annotated notes: "So in original. Probably should be 'General'." 31 U.S.C. § 3730(e)(4)(A).

the industry in question, as the Seventh, Eleventh, and D.C. Circuits have held,[2] or in *all* cases, even absent disclosure of such universality, as the Third, Ninth, and Tenth Circuits have held.[3]

For the former group of circuits, a *qui tam* action is barred, even absent a prior disclosure identifying the defendant *by name*, because the disclosure of such universality is, in effect, a specific identification of the defendant: The disclosure identifies *every* participant in the industry as a wrongdoer, and thus a *more* specific identification (i.e., identification *by name*) is unnecessary for application of the bar. Thus, these

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[2] *See Cooper v. Blue Cross and Blue Shield of Fla., Inc.*, 19 F.3d 562, 566 (11th Cir. 1994) ("*Cooper*") (applying "identified" test where "widespread *but not universal* – fraud in an industry was revealed" (emphasis added)); *United States, ex rel. Findley v. FPC-Boron Employees' Club*, 105 F.3d 675, 687 (D.C. Cir. 1997) ("*Findley*") (applying "easily identifiable" test where disclosures revealed misconduct occurring "throughout the federal government" such that "their relevance cannot be confined to specific agencies"); *United States, ex rel. Gear v. Emergency Med. Assocs. of Ill., Inc.*, 436 F.3d 726, 728-29 (7th Cir. 2006) ("*Gear*") (applying "directly identifiable" test where disclosure revealed fraud investigation of "the nation's 125 medical schools").

[3] *See United States ex rel. Fine v. Sandia Corp.*, 70 F.3d 568, 569-73 (10th Cir. 1995) ("*Fine*") (applying "easily identifiable" test absent disclosure of universal fraud in relevant industry); *United States and Harshman v. Alcan Elec. and Eng'g, Inc.*, 197 F.3d 1014, 1016-19 (9th Cir. 1999) ("*Harshman*") (same); *United States, ex rel. Pritsker v. Sodexho, Inc.*, No. 09-1975, 2010 WL 438437, at *3 (3d Cir. Feb. 9, 2010) ("*Pritsker*") (*see* 1a-10a) (same) (affirming and adopting No. 03-6003, 2009 WL 579380, at *10-11 (E.D. Pa. Mar. 6, 2009) (*see* 14a-58a)).

courts have held the defendant "easily identifiable" in the sense that, because the defendant has already been specifically identified (albeit without being named), the defendant's name itself is readily determinable.

For the latter group of circuits, by contrast, a defendant that was "easily identifiable" was not "specifically identified" in any sense. For these courts, a *qui tam* action is barred where there has been only a potential, rather than an actual, public disclosure of the defendant's identity.

Accordingly, this Court should grant certiorari for two principal reasons.

First, the circuit split leaves *qui tam* plaintiffs (also known as "relators") and courts in doubt as to the proper scope of the public disclosure bar. In 1997, the D.C. Circuit noted the split, stating that each of the circuits to have addressed the public disclosure bar "agrees on one thing . . . : the language of the statute is not so plain as to clearly describe which cases Congress intended to bar." *Findley*, 105 F.3d at 681. Subsequent circuit decisions have done little to clarify the law or to resolve the conflict. Worse yet, the "easily identifiable" test is so malleable that it has expanded the bar vastly beyond what the bar's plain language – requiring a "public disclosure" rather than a "potential public disclosure" – provides. It is no accident that *all* circuits adopting the "easily identifiable" test have upheld dismissal under the public disclosure bar. The issue is important: Application of the wrong test

not only requires dismissal of meritorious *qui tam* complaints but also denies relators a significant incentive to identify wrongdoers that no statutory source has identified. Absent that incentive, fewer relators will identify such wrongdoers, fewer *qui tam* actions will be brought, and fewer fraud losses will be recovered for the public's benefit.

Second, four of the five circuits applying the "easily identifiable" test, *see* nn.2, 3, *supra*, have, under the guise of interpretation, erroneously replaced the public disclosure bar with the "government knowledge" bar, which was repealed in the 1986 amendments to the FCA. This erroneous reading must be corrected. Since 1943, after this Court permitted a *qui tam* complaint that directly copied its allegations from a government indictment, the FCA has included a bar to prevent such "parasitic" lawsuits. Until 1986, the bar was triggered if the *qui tam* complaint was based on information already in the *government's* possession. That provision was accordingly known as the "government knowledge" bar. As relevant here, that bar was problematic because of the government's lax enforcement of the FCA. A *qui tam* complaint was doomed by that bar if the relevant information was buried in a government file – yet, too often, the government would not act on the information. As a result, the public's losses to fraud would be remedied by neither of the FCA's enforcement options (i.e., a *qui tam* action or an action directly by the government). Thus, in 1986, Congress changed the bar's trigger from information in the government's

possession to information in the public domain. In this way, the bar remained a safeguard against parasitic lawsuits, but thenceforth ensured the public that the allegations at issue could not be neutralized by government inaction.

Unfortunately, the Third, Ninth, Tenth, and D.C. Circuits, in applying the "easily identifiable" test, have answered the question "identifiable by whom?" with the phrase "by the government." According to these courts, the public disclosure bar is triggered when public disclosures enable the *government* to investigate the case and make a decision whether to prosecute. In so holding, these courts have improperly made the bar depend once again on the presence of information in the government's hands. Moreover, these courts have compounded the repealed bar's vice by having the current bar be triggered not just by information *in* the government's files but also by information that *could have been in* the government's files if the government *were to have acted* on its existing information. Thus, these courts have improperly resurrected the "government knowledge" bar, but in a more hypothetical, hence more noxious, form. Under their mistaken holdings, a *qui tam* action is doomed when the information available to the government *could have* led it to investigate, identify wrongdoers, and decide whether to prosecute – even if the government never actually took those steps and instead remained wholly inactive. Consequently, a relator's allegations can once again be neutralized by

government inaction, contrary to the congressional intent underlying the public disclosure bar.

In sum, the decision of the Third Circuit below – like that of the Ninth and Tenth Circuits – to uphold dismissal under the public disclosure bar was erroneous. No statutory source named or otherwise specifically identified any Respondent. Moreover, because no statutory source disclosed universal fraud in Respondents' industry, the "easily identifiable" test was inapplicable. Accordingly, this Court's review is warranted by the circuit split regarding the proper identification test and by the holdings that have over-expanded the public disclosure bar and improperly resurrected the "government knowledge" bar.

B. The FCA

As applicable here, the FCA imposes civil liability on anyone who "knowingly . . . causes to be presented[ ] to an officer or employee of the United States Government . . . a false or fraudulent claim for payment or approval . . . ," 31 U.S.C. § 3729(a)(1), or "knowingly . . . causes to be made or used[ ] a false record or statement to get a false or fraudulent claim paid or approved by the Government," *id.* § 3729(a)(2).[4] A person who violates the FCA is liable to the government for treble damages and civil penalties. *Id.* § 3729(a). An FCA action may be brought in two

[4] The 2009 amendments to 31 U.S.C. § 3729(a) are not relevant to the issue presented herein.

ways. The Attorney General may bring an action, *id.* § 3730(a), or, under the FCA's *qui tam* provisions, a private person (known as a "relator") may bring an action "for the person and for the United States Government." *Id.* § 3730(b)(1).

The *qui tam* complaint and the relator's material evidence must be served on the government. *Id.* § 3730(b)(2). The complaint is filed under seal for 60 days. *Id.* The government may then elect to intervene and proceed with the action, or decline and thereby allow the relator to conduct the action. *Id.*; *id.* § 3730(b)(4). The government is entitled to most of the recovery – at least 75% if the government proceeds with the action, and at least 70% if it does not so proceed – with the balance going to the relator. *Id.* § 3730(d)(1) & (2).

The FCA bars certain actions, including an action "based upon the public disclosure of allegations or transactions in a criminal, civil, or administrative hearing, in a congressional, administrative, or Government Accounting Office report, hearing, audit, or investigation, or from the news media, unless the action is brought by the Attorney General or the person bringing the action is an original source of the information." *Id.* § 3730(e)(4)(A).[6] This provision, known

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[5] *See* n.1, *supra*.

[6] The "original source" exception to the public disclosure bar is inapplicable where, as here, the bar itself is not triggered. Accordingly, the exception is not at issue on this Petition.

as the "public disclosure" bar, was enacted in the 1986 amendments to the FCA. *Findley*, 105 F.3d at 681. The predecessor provision, repealed in 1986, barred an action "'based upon evidence or information in the possession of the United States . . . at the time such suit was brought.'" *Id.* at 680 (quoting 31 U.S.C. § 3730(b)(4) (1982)).

C. Petitioner's Case

1. Petitioner's Allegations

This *qui tam* action was commenced in 2003. Petitioner, relator Robert Pritsker, alleged that Respondents, all food service management companies ("FSMCs"), perpetrated a significant fraud in the $10 billion National School Lunch Program and School Breakfast Program (collectively, the "Program"). (78a-79a, 85a.) According to the complaint, Respondents, pursuant to their contracts with local school food authorities ("SFAs") to provide food for the Program, requested the SFAs to provide cost reimbursements, but the amounts requested did not reflect deductions for rebates, credits, and allowances (collectively, "rebates") received by Respondents from their own suppliers.[7] (*Id.*) Thus, the reimbursements sought from

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[7] Of the contracts alleged by Petitioner, some prohibited rebate retention; others did not address rebate retention; and still others contained provisions, inserted by the FSMCs, permitting rebate retention. (92a, 177a; *cf.* 171a-72a (1996 GAO report stating that 37% of FSMC contracts prohibit rebate retention, 40% are silent concerning rebate retention, and 18% permit

(Continued on following page)

the SFAs were artificially high. Petitioner further alleged that the SFAs' reimbursement of Respondents for costs that were not net of rebates violated federal regulatory requirements applicable to SFAs.[8] (87a-91a.) As a result of that failure and violation, the complaint concluded, Respondents caused the SFAs, when claiming corresponding reimbursement from state agencies ("SAs"), to certify falsely that the costs incurred were regulatorily compliant, and consequently the SAs made a similarly false certification when claiming corresponding reimbursement from the Food and Nutrition Service ("FNS"), which is part of the U.S. Department of Agriculture ("USDA"). (90a-91a, 94a.) Knowingly causing the submission of a false claim for federal payment violates the FCA. (140a-41a.)

Petitioner's allegations concerned only cost-reimbursable contracts, in which the FSMC bills the SFA for the FSMC's costs, plus management and administrative fees. (91a 92a, 176a.) Petitioner's allegations did not concern fixed-rate contracts, in which the FSMC agrees to charge the SFA meals at a fixed rate per meal served, regardless of the actual cost per

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rebate retention).) Petitioner alleged that, regardless of the contractual language, Respondents retained the rebates *knowing* that SFAs were prohibited by regulation from expending Program funds on unallowable costs, such as costs that are not net of rebates, *see* n.8, *infra*. (91a-92a.)

[8] Below, the Third Circuit did not reach the issue of whether OMB Circular A-87, which requires that allowable costs be net of rebates (87a-88a), applied to FSMC-SFA contracts. (*See also* 21a, 54a-55a.)

meal to the FSMC. (169a-70a, 176a, 182a.) Under the applicable regulations, the rebate retention issue at the heart of this case is irrelevant to fixed-rate contracts because the fixing of the rate obviates the need for cost restraints like the prohibition against rebate retention. (87a-88a, 171a n.2, 176a, 182a-83a.)

2. The Asserted Public Disclosures of Rebate Retention by FSMCs, and Petitioner's Own Investigation and Allegations

Prior to commencement of this action on October 30, 2003, statutory sources disclosed the generic practice of rebate retention by FSMCs, but did not name or otherwise specifically identify any Respondent as a wrongdoer (i.e., as having engaged in rebate retention). A 1996 GAO Report simply mentioned rebate retention by unnamed FSMCs.[9] (18a-19a, 150a, 169a-72a.) An April 2002 audit report by the Office of the Inspector General ("OIG") of the USDA mentioned rebate retention by two unnamed FSMCs at 7 of the 19 SFAs reviewed[10] (20a, 175a-99a), and regional audit reports either mentioned rebate retention by unnamed FSMCs (19a (quoting Feb. 2001 audit

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[9] Excerpts from the 1996 GAO report appear in the Appendix to the Petition. The full text of the report is available at http://www.gao.gov/archive/1996/rc96217.pdf.

[10] Excerpts from the April 2002 audit report appear in the Appendix to the Petition. The full text of the report is available at http://www.usda.gov/oig/webdocs/27601-27-Ch.pdf.

report[11])) or found no rebate retention at all (19a (citing Mar. and Apr. 2001 audit reports[12])). Five lines of Congressional testimony by the USDA's Inspector General, while revealing a dispute between OIG and OMB regarding the permissibility of FSMCs' rebate retention, did not name or otherwise specifically identify any FSMCs. (23a-24a, 55a, 201a.) Finally, a June 2002 news article referred to the April 2002 audit report, but explicitly disclaimed any ability to identify the FSMCs referenced in that report. (202a-06a.)

Petitioner, a former owner-operator of food-service establishments who had and has children in public school, conducted his own investigation to identify FSMCs that were retaining rebates. (70a, 81a.) His investigation uncovered (i) the identities of FSMCs that retained rebates (i.e., Respondents), (ii) the false certifications by SFAs to SAs and by SAs to federal authorities, which certifications were never mentioned in the government reports, and (iii) the link that the false certifications created between the FSMCs' retention of rebates and the FCA violations ultimately alleged in the complaint. (63a-142a.) Thus, Petitioner's investigation revealed the fraudulent portion of the

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[11] The full text of the February 2001 audit report is available at http://www.usda.gov/oig/webdocs/27601-10-At.pdf.

[12] The full texts of the March and April 2001 audit reports are available respectively at http://www.usda.gov/oig/webdocs/27601-9-Te.PDF and http://www.usda.gov/oig/webdocs/27099-15-SF.PDF.

transactions – i.e., the series of false certifications, and consequent FCA liability – as well as the identities of the fraudsters. Notwithstanding the substantial fruits of Petitioner's investigation, Respondents have argued, and the courts below have incorrectly concluded, that Respondents, though never identified as wrongdoers in the reports, were "easily identifiable," and thus that the public disclosure bar required dismissal.

In addition, nothing in these reports indicates that rebate retention was a universal practice among FSMCs having cost-reimbursable contracts with SFAs. The April 2002 audit, while noting that at least 19 FSMCs in the nation had contracts with SFAs and that 1,648 SFAs (out of 19,329 SFAs in the nation) had contracts with FSMCs,[13] reviewed 8 FSMCs and 65 SFAs. (175a-78a, 183a, 199a.) Six of the 8 FSMCs, and 19 of the 65 SFAs, had cost-reimbursable contracts. (175a-78a, 185a, 190a, 199a.) *Tellingly, the April 2002 audit found that only 2 of those 6 FSMCs (i.e., 33%) were retaining rebates from only 7 of those 19 SFAs (i.e., 37%).* (175a-78a, 183a, 185a, 199a.) In addition, those 2 FSMCs had contracts with only 18% of the 1,648 SFAs. (193a.) Moreover, the 1996 GAO report stated that, while approximately 91% of FSMC-SFA contracts were cost-reimbursable (169a-70a), only 18% of FSMC-SFA contracts contained terms

[13] The April 2002 audit did not state how many of these 1,648 SFAs that contracted with FSMCs had cost-reimbursable contracts and how many had fixed-rate contracts.

purporting to permit rebate retention by FSMCs (172a). Even Petitioner's original *pro se* complaint – which for some reason the district court cited (42a) in lieu of Petitioner's amended complaint, drafted by counsel – alleged that the three defendant FSMCs in this case controlled "about 45%" of FSMC-SFA contracts.[14] (72a.) These data hardly indicate that rebate retention was universal among FSMCs having cost-reimbursable contracts with SFAs.

D. Proceedings in the District Court

On October 30, 2003, Petitioner, then *pro se*, filed a *qui tam* complaint pursuant to 31 U.S.C. §§ 3729 *et seq.* (63a-76a.) In March 2005, the government declined to intervene in the action. (26a.) Having retained counsel, Petitioner filed an amended complaint on August 1, 2007. (77a.) Petitioner alleged two basic FCA claims: that Respondents' retention of rebates caused the SFAs and SAs to present false claims to the government (the "rebate claim") and that Respondents' failure to procure food from suppliers pursuant to full and open competition improperly increased the costs incurred by SFAs and

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[14] Rather than this specific allegation in the *pro se* complaint, the district court actually cited the *pro se* complaint's tentative and conclusory allegation that the three defendants "are believed to control 45% or more" of FSMC-SFA contracts. (42a (quoting 71a).) In any event, an allegation in Petitioner's *own* complaint in this action cannot constitute a public disclosure for purposes of the bar.

thus caused the SFAs and SAs to present false claims to the government (the "procurement claim").[15] (91a-139a.) At all times, the basis of federal jurisdiction was 28 U.S.C. §§ 1331 and 1345. (69a, 80a.)

In December 2008, Respondents moved to dismiss the amended complaint. On March 6, 2009, the district court granted the motions. The court dismissed the rebate claim under the public disclosure bar (30a-51a), holding that there had been a "public disclosure" (30a-45a) and that Petitioner was not an "original source" of that information (45a-51a). As to the procurement claim, the court found that there had not been a public disclosure. (42a-45a.) However, as to both claims, the court concluded that neither Respondents nor their client SFAs had committed a regulatory violation leading to FCA liability, and that the amended complaint therefore failed to state a claim. (52a-58a.)

On April 3, 2009, Petitioner filed a timely notice of appeal. (7a.)

E. Proceedings in the Third Circuit

On February 9, 2010, the Third Circuit affirmed the district court's judgment. (1a-10a.) First, without discussion, the Third Circuit affirmed the dismissal of the rebate claim under the public disclosure bar, adopting the district court's analysis and declining to

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[15] The procurement claim is not at issue on this Petition.

decide whether the rebate claim failed to state a claim. (8a-9a.) Second, the Third Circuit affirmed the dismissal of the procurement claim for failure to state a claim. (9a-10a.) The Third Circuit exercised appellate jurisdiction under 28 U.S.C. § 1291.

On February 23, 2010, Petitioner requested panel rehearing and rehearing en banc. The Third Circuit denied that relief on March 16, 2010. (61a-62a.)[16]

This Petition followed.

REASONS FOR GRANTING THE PETITION

I. The Circuits Have Split Over the Circumstances Under Which to Apply the "Identified" and "Identifiable" Tests

The six circuits to have addressed the identification issue have divided over the circumstances under which the "identified" and "identifiable" tests apply. The leading cases are the Eleventh Circuit's decision in *Cooper*, the Tenth Circuit's decision in *Fine*, and the D.C. Circuit's decision in *Findley*. Explicitly, *Cooper* held that, where public disclosures do not reveal universal fraud within the industry in question, the public disclosure bar is not triggered unless the *qui*

[16] On February 24, 2010, Petitioner also moved the Third Circuit for relief under Federal Rule of Civil Procedure 60(b)(6). On March 9, 2010, the Third Circuit denied the motion. The motion and denial are not at issue on this Petition.

tam defendant is named or otherwise specifically identified in those disclosures. Implicitly, *Cooper* also held that, where public disclosures *do* reveal universal fraud within the industry, the bar is triggered even if the *qui tam* defendant is not so named or identified. Consistent with *Cooper*, *Findley* held that, where public disclosures have revealed universal fraud within the industry in question, the public disclosure bar is triggered – even though the *qui tam* defendant was not named in the public disclosures – because the defendant was "easily identifiable" by the government. Implicit in *Findley* was the holding that a public disclosure of universal fraud in an industry effectively identifies *every* industry participant as a wrongdoer, and thus that a more specific identification (i.e., by name) is unnecessary.

By contrast, *Fine* held that the public disclosure bar is triggered where the *qui tam* defendant is "easily identifiable" by the government. The *Fine* court applied its holding categorically, without drawing any distinction between universal and non-universal fraud.

This split, between *Fine* and progeny, on the one hand, and *Cooper*, *Findley*, and progeny, on the other hand, has created confusion concerning whether the "easily identifiable" test applies in all circumstances, or only where a prior public disclosure has revealed universal fraud within the industry in question. In Petitioner's view, the approach of *Fine* is incorrect for two reasons. First, it incorrectly reads section 3730(e)(4)(A) as if it conditions the bar on a "potential

public disclosure" rather than simply a "public disclosure." Second, the "identifiable" test is so capacious that it expands the bar beyond what Congress intended, to the detriment of non-parasitic relators – who have revealed the identities of wrongdoers where public disclosures have not – and, ultimately, of the public fisc. Accordingly, a grant of certiorari is warranted so that this Court may eliminate the confusion created by the circuit split and correct the errors in the *Fine* approach.

A. The Eleventh Circuit Has Adopted the "Identified" Test

The Eleventh Circuit, which was the first court of appeals to address the issue presented herein, adopted the "identified" test in *Cooper v. Blue Cross and Blue Shield of Florida, Inc.*, 19 F.3d 562 (11th Cir. 1994). There, the court held that the public disclosure bar does not require dismissal of a *qui tam* action if the defendant was not "mentioned by name or otherwise specifically identified" in publicly disclosed allegations of fraud. *Id.* at 566; *see id.* (bar not triggered if defendant "was not specifically named or otherwise directly identified" in public fraud disclosures). *Cooper* concerned "Medicare Second Payer" ("MSP") fraud, in which an insurer with primary responsibility for paying a medical claim improperly refuses to pay and falsely states that the claim should have been submitted first to Medicare, thereby causing Medicare to pay claims that should have been paid (or paid first) by the insurer. *Id.* at 564. The

relator, a federal employee who was over 65 and thus covered by both Medicare and the federal employees' insurance administered by Blue Cross and Blue Shield of Florida, Inc. ("BCBSF"), filed a *qui tam* action against BCBSF alleging MSP fraud.

BCBSF moved to dismiss under the public disclosure bar, citing a number of prior public disclosures of MSP fraud. The Eleventh Circuit addressed the disclosures in two groups, depending on whether the disclosure actually named BCBSF.

First, the court held that the bar was not triggered where the public disclosures did not name BCBSF – even though those disclosures set forth "specific allegations of MSP fraud against other insurance companies," including Blue Cross Blue Shield of Georgia. *Id.* at 566. The court explained that holding the bar inapplicable absent public disclosure of "allegations *specific to a particular defendant*" will "increase[ ] the chances that every instance of specific fraud will be revealed." *Id.* (emphasis added). Significantly, the court stated that "[t]o hold otherwise would preclude any *qui tam* suit once widespread – *but not universal* – fraud in an industry was revealed."[17] *Id.* (emphasis added). BCBSF's position, the court concluded, "would hamper the discovery of

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[17] By this language, the *Cooper* court implicitly held that, where fraud *is* universal in an industry, naming or other specific identification is not necessary to trigger the bar, presumably because the assertion of universality itself identified *every* industry participant as a wrongdoer.

specific instances of fraud and the recovery of losses." *Id.* Indeed, under BCBSF's approach, "any disclosure – in a suit against a [defense] contractor or a media account of 'industry-wide' corruption for instance – could bar a suit by a *qui tam* plaintiff against *any* member of the defense industry. This result is at odds with the purpose of the 1986 amendments." *Id.* at 566 n.7.

Second, the court held that, where the public disclosures did name BCBSF, the bar is still not triggered if the disclosures did not name BCBSF *as a wrongdoer*. *Id.* at 567. Thus, where a disclosure mentions the *qui tam* defendant by name, but without implicating it in the wrongdoing alleged by the *qui tam* complaint, the bar is not triggered.[18]

In sum, *Cooper* holds that, where widespread *but not universal* fraud in an industry is publicly disclosed, the public disclosure bar is not triggered – even if the disclosure includes specific allegations of fraud – unless the *qui tam* defendant is "mentioned by name or otherwise specifically identified" as a wrongdoer in the disclosure. *Id.* at 566.

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[18] The court further held that one of the public disclosures at issue did name BCBSF as a wrongdoer, but that the relator was an "original source." 19 F.3d at 567-68.

B. The Other Circuit Decisions

The other five circuits to address the issue have held the bar triggered where the *qui tam* defendant is "easily identifiable." However, these five circuits are divided over whether the "easily identifiable" test applies categorically, or only where there has been public disclosure of universal fraud within the *qui tam* defendant's industry.

1. The Tenth Circuit Has Adopted the "Identifiable" Test

In *United States ex rel. Fine v. Sandia Corporation*, 70 F.3d 568 (10th Cir. 1995), the Tenth Circuit held that the public disclosure bar is triggered where "the government has already identified the problem and has an *easily identifiable* group of probable offenders." *Id.* at 572 (emphasis added). *Fine* concerned the "taxing" of federal nuclear waste funds, a practice in which a nuclear laboratory operated by a contractor with the U.S. Department of Energy ("DOE") devotes a percentage of funds received under the Nuclear Waste Policy Act ("NWPA") to discretionary research and development, when such funds allegedly should have been devoted exclusively to research concerning storage and disposal of radioactive waste. *Id.* at 569. A 1990 GAO report had identified the practice, examined three out of nine such laboratory contractors (Los Alamos, Lawrence Livermore, and Sandia), and concluded that Los Alamos and Lawrence Livermore – but not Sandia – had

engaged in taxing. *Id.* The report had also indicated that DOE's general counsel had not yet decided whether taxing was permissible. *Id.* In addition, a congressional hearing in 1991 had addressed taxing by an unspecified number of such laboratory contractors, but did not identify Sandia (or any other specific laboratory contractor, for that matter) as having engaged in the practice. In 1992, the relator filed a *qui tam* action against Sandia, alleging that Sandia had imposed a 2.5% tax on its NWPA funds in 1991 and 1992, and, therefore, falsely certified to the federal government that its spending of NWPA funds complied with applicable rules and regulations. Sandia moved to dismiss under the public disclosure bar, citing the 1990 report and 1991 hearing.

The Tenth Circuit affirmed the dismissal of the action under the public disclosure bar, holding that the report and hearing had disclosed the practice of taxing, had identified two laboratory contractors (out of nine) as having engaged in the practice, and had indicated DOE's "acquiescence" in the practice. *Id.* at 571. Thus, the court concluded, the disclosures had "sufficiently alerted the *government* to the likelihood that Sandia would also 'tax' nuclear waste funds in the future." *Id.* (emphasis added). The court explained that the two disclosures "set the *government* squarely on the trail of the alleged fraud without [the relator's] assistance . . . ." *Id.* (emphasis added). The court further stated that, "[g]iven the DOE's acquiescence in the practice and the limited number of laboratories under its control, we can *assume* that

any *further* investigation into the 'taxing' of nuclear waste funds *would* include Sandia." *Id.* (emphasis added). The court found *Cooper*'s facts "easily distinguishable," because identifying the defendant in *Cooper* assertedly involved "combing through the private insurance industry in search of fraud," whereas identifying Sandia involved "examining the operating procedures of nine, *easily identifiable*, DOE-controlled, and government-owned laboratories." *Id.* at 571-72 (emphasis added). Finally, despite the disclosures' identification of only two laboratory contractors as having taxed, and despite the court's recognition that the 1990 report found only "some" of the laboratories to have taxed, *id.* at 569, the court asserted the other seven contactors to be "probable offenders." *Id.* at 572. The court's opinion does not reveal the basis for that assertion.[19] In any event, nothing in the opinion demonstrated that the practice of taxing was actually universal within the industry, and the court's holding did not depend on whether the practice was or was not universal within the industry.

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[19] In *In re Natural Gas Royalties Qui Tam Litigation*, 562 F.3d 1032 (10th Cir.), *cert. denied*, 130 S. Ct. 301 (2009), the Tenth Circuit revisited and reaffirmed its holding in *Fine*.

Fine contains a number of weaknesses.

First, the 1991 hearing never identified *any* laboratory contractor as having taxed, and the 1990 report specifically identified Los Alamos and Lawrence Livermore, *but not Sandia*, as having taxed. Thus, it is difficult to see how the court could conclude that either disclosure had identified Sandia in any way as having engaged in the practice.

Second, the court simply "*assume*[*d*]" that, *if* there had been investigation following the two disclosures, such investigation "*would*" have identified Sandia. Thus, the court based its application of the bar not on an actual public disclosure, as the public disclosure bar requires, but rather on an assumed, hypothetical disclosure, in disregard of the bar's plain language. Indeed, by finding a likelihood that Sandia would tax "in the future," the court was effectively acknowledging the failure of the report and hearing to disclose that Sandia had taxed in the past. The public disclosure bar's wording requires that the test for public disclosure be whether the transactions *were* set forth *in* the public disclosure at issue, not whether they *would be* disclosed *after* that disclosure.

Third, even assuming *arguendo* that governmental indecision concerning the permissibility of taxing was "acquiescence" in the practice, the court held such acquiescence to be a basis for concluding that there had been a public disclosure. But the government's view on the ultimate issue of liability – i.e., whether taxing was permissible or not – is

irrelevant to the public disclosure bar. The bar concerns whether there was a public disclosure, not whether what was publicly disclosed violated the law.

Fourth, by repeatedly emphasizing that the defendant was "easily identifiable," 70 F.3d at 572, rather than *actually identified*, the court not only compounded the problem of hypotheticality, but created a rule that is poorly suited to threshold determinations. Whether a defendant is "identifiable" is ultimately a subjective inquiry into potentiality, and, brought to its logical conclusion, will require a relator's complaint to allege not only the defendant's wrongdoing, but also, and bizarrely, the difficulty with which the relator came to identify the defendant as a wrongdoer notwithstanding any public disclosures. A sounder rule would require the relator to allege, besides the defendant's wrongdoing, only the objectively verifiable fact of whether the defendant was previously identified in a public disclosure.

Fifth, the court's reliance on the fact that there was a relatively small number of participants in the industry as a whole elided the important difference between being identifiable merely *as an industry member* and being identifiable *as a wrongdoer*. *Cf. Cooper*, 19 F.3d at 567 ("identified" means identified as a wrongdoer). It may well have been easy to identify all nine members of a highly regulated industry. But mere identification of entities as industry members is insufficient to trigger the bar absent public disclosures implicating those entities in wrongdoing.

Sixth, contrary to *Fine*, 70 F.3d at 572, nothing in *Cooper* suggested that anyone had to "comb[ ] through" an entire industry in search of a particular wrongdoer. Indeed, the relator there, far from searching for a wrongdoer, had been approached by the wrongdoer itself – BCBSF – which made its misrepresentations directly to the relator. The reference to "combing through" an industry was simply an unsuccessful effort to distinguish *Cooper* factually, prompted by the strength of *Cooper*'s reasoning. Thus, *Cooper* lent no support to the *Fine* court's conclusion that difficult identification does not trigger the bar and that easy identification does.

2. The D.C. Circuit Has Held That, Where Public Disclosures Revealed Universal Fraud, the Bar Is Triggered Because the Defendants Were Effectively Identified Even Without Being Named, and That They Were "Easily Identifiable" by Name

Although only the third court of appeals to address the identification issue, the D.C. Circuit, in *United States, ex rel. Findley v. FPC-Boron Employees' Club*, 105 F.3d 675 (D.C. Cir. 1997), noted the existing split between the Tenth and Eleventh Circuits. *Id.* at 678, 681, 687. *Findley* concerned federal employees' clubs that operate vending machines on federal property but that retain the profit instead of yielding it to the government. *Id.* at 678. Three public disclosures had revealed the practice, as engaged in

by "postal employees' clubs," "[f]ederal employee . . . groups," and personnel at "military exchanges," respectively. *Id.* at 679, 685, 686. Following these disclosures, the relator brought a *qui tam* action against all employee clubs of the U.S. Bureau of Prisons and the U.S. Department of Justice that retained the profits from vending machines on federal property. *Id.* at 678. The district court dismissed the action under the public disclosure bar, citing the three disclosures.

The D.C. Circuit affirmed, holding that the disclosures implicated the entire federal government and were not agency-specific: "The disclosures recognize that the practice occurs *throughout the federal government*, thus their relevance *cannot be confined to specific agencies.*" *Id.* at 687 (emphasis added). As a consequence, the court continued, the disclosures "specifically identify" not only the "nature of the fraud" but also "the federal employee actors engaged in the allegedly fraudulent activity." *Id.* The court then echoed the *Fine* court's effort to distinguish *Cooper* factually: "Little similarity exists between combing through the myriad of transactions performed by the various defense contractors in search of fraud and finding *easily identifiable* federal employee organizations that provide vending services on federal property." *Id.* (emphasis added) (citing *Fine* and *Cooper*).

By stating that the defendants were both "specifically identif[ied]" *and* "easily identifiable," *id.*, *Findley* held that public disclosure of *universal* wrongdoing in an industry is itself a sufficiently specific

identification of the wrongdoers and that therefore further specific identification (i.e., by name) is as easy as it is unnecessary. Indeed, the D.C. Circuit, in addition to calling the wrongdoers "easily identifiable," asserted that the relator's allegations "substantially repeat what the public already knows and add *only* the identity of particular employees' clubs engaged in the questionable and previously documented generic practice." *Id.* (emphasis added). By this remark, the court was asserting not that particularized identification was immaterial or collateral – after all, no lawsuit is even possible without a *named* defendant[20] – but rather that the defendants had *already* been so identified. The disclosures, by revealing that the wrongdoing existed throughout the federal government and was not limited to particular agencies, *see id.* at 687, effectively identified the defendants by identifying *every* participant in the industry as a wrongdoer. *Findley*'s holding is therefore consistent with *Cooper*'s implicit holding that, when a public disclosure reveals *universal* fraud in an industry, that revelation alone constitutes sufficiently specific identification of the wrongdoers to warrant application of the bar and that further specific identification (i.e., by name) adds nothing of critical importance for purposes of the bar.[21]

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[20] *Cf. In re Natural Gas Royalties Qui Tam Litig. (CO2 Appeals)*, 566 F.3d 956, 962 (10th Cir. 2009) ("The defendant's identity is a material element of a fraud claim.").

[21] Point I.B.2., *supra*, addresses *Findley*'s use of the "identified" and "identifiable" tests. Point II, *infra*, addresses *Findley*'s

(Continued on following page)

3. Other Circuits Have Not Resolved the Confusion

The circuits addressing the identification issue post-*Findley* have neither exhaustively analyzed nor shed additional light on the subject.

a. *Harshman*: In *United States and Harshman v. Alcan Electrical and Engineering, Inc.*, 197 F.3d 1014 (9th Cir. 1999), a relator filed a *qui tam* complaint three weeks *after* filing a non-*qui tam* complaint. *Id.* at 1016. The *qui tam* defendants moved to dismiss under the public disclosure bar, alleging that the allegations in the *qui tam* complaint had been publicly disclosed in the prior, non-*qui tam* complaint. *Id.* at 1017. The relator argued, *inter alia*, that there was no public disclosure because the earlier complaint did not identify the defendants in the *qui tam* action. *Id.* at 1018. The Ninth Circuit rejected that argument, holding, somewhat cryptically, that dismissal is required under the public disclosure bar where the disclosures, even if not specifically naming a *qui tam* defendant, "encompassed [the relator's] allegations against them." *Id.* The Ninth Circuit also cited *Findley* for its reliance on the "easily identifiable" test (though the Ninth Circuit ignored *Findley*'s concomitant reliance on the "specifically identif[ied]" test). *Id.* at 1019. The Ninth Circuit did not cite *Cooper*. In its conclusion, the Ninth Circuit, noting

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answer to the question "identifiable by whom?" and hence *Findley*'s improper resurrection of the "government knowledge" bar.

that the prior complaint alleged a "narrow class of suspected wrongdoers," relied on an attenuated version of the "easily identifiable" test: "[T]he instant case is similar to [*Fine*], in that the government, as regulator and owner [of the projects alleged in the prior complaint], *presumably* would have *ready access* to documents identifying those contractors. This ready access makes it *highly likely* that the government *could easily identify* the contractors at issue." *Id.* (emphasis added). Moreover, in relying on the relatively small number of industry participants, the *Harshman* court made the same mistake that the *Fine* court made, namely, to conflate the issue of whether an entity is identifiable as an industry member with the issue of whether an entity is identifiable as a wrongdoer. Again, merely identifying an entity as an industry member is insufficient to trigger the bar absent a public disclosure implicating the entity in wrongdoing.

b. *Gear*: In *United States, ex rel. Gear v. Emergency Medical Associates of Illinois, Inc.*, 436 F.3d 726 (7th Cir. 2006), a relator filed a *qui tam* complaint alleging that the defendants fraudulently billed Medicare for services by residents in a residency program as if the services had been performed by attending physicians. *Id.* at 727. Medicare was authorized to reimburse for services performed by attending physicians but not by residents. *Id.* The district court granted summary judgment in the defendants' favor under the public disclosure bar because of prior public allegations that Medicare "was

being billed for services provided by residents as if attending physicians had actually performed the services." *Id.* at 728.

Affirming, the Seventh Circuit first observed that, in connection with the public disclosures, the government had already investigated *all* of the nation's 125 medical schools, and that teaching hospitals associated with those 125 schools were also informed that they were subject to audit. *Id.* at 728. The Seventh Circuit then rejected the argument that, "for there to be public disclosure, the specific defendants named in the lawsuit must have been identified in the public records." *Id.* at 729. The court explained: "The disclosures at issue here were of industry-wide abuses and investigations. Defendants were implicated. Industry-wide public disclosures bar *qui tam* actions against any defendant who is directly identifiable from the public disclosures." *Id.* The court cited *Fine*, *Findley*, and *Harshman*, but did not cite *Cooper*.

Gear, like *Findley*, is consistent with *Cooper*'s implicit holding that, where public disclosures *do* reveal universal fraud within an industry, the public disclosure bar applies without more specific identification of the wrongdoers (i.e., without any actual naming of the wrongdoers). The disclosure of universality sufficiently identifies the defendants by identifying *every* participant in the industry. Thus, identification of them *by name* is unnecessary.

c. ***Pritsker:*** The Third Circuit's decision simply affirmed the district court's dismissal of the rebate

claim on public disclosure grounds and, without discussion, adopted the district court's analysis. (8a-9a.) The district court had reviewed *Findley*, *Fine*, *Cooper*, and *Gear*, and concluded that the public disclosure bar is not triggered where the alleged fraud occurred on a "transactional level" – a phrase left unexplained by the opinion – and where individual perpetrators are "difficult to discern." (38a-40a.) By contrast, the district court, evidently having noted *Fine*'s assertion that the government there had identified the problem and had "an easily identifiable group of probable offenders," 70 F.3d at 572, further concluded that the bar is triggered where the wrongdoer can be specifically identified with "minimal effort," or where "the disclosed fraud could only be attributed to an ascertainable number of possible perpetrators" (40a). Accordingly, the district court, applying *both* the "identified" and "identifiable" tests, held that Respondents were "either already identified or easily identifiable as entities potentially involved in the publicly disclosed industry-wide scheme." (42a.)

This holding was erroneous for several reasons.

First, the bar is not triggered by identification of an entity as "potentially" involved in publicly disclosed wrongdoing. The use of the word "potentially" needlessly expands the public disclosure bar beyond the bar's plain language – which requires no less public disclosure of the wrongdoer's identity than of its wrongdoing – to require dismissal of meritorious, non-parasitic complaints, such as Petitioner's. Nothing supports the district court's assertion that the bar

is triggered by merely possible participation in publicly disclosed wrongdoing, rather than by public disclosure of actual participation therein.

Second, the district court's holding that at least one or more Respondents were "already identified" was based on an incorrect legal standard. The only record evidence cited by the district court in support of the assertion that any Respondent was "already identified" was the 1996 GAO report. (41a-42a.) That report, the district court stated, "specifically mentioned Marriott, Sodex[h]o's predecessor, and Aramark as large FSMCs that typically contract with local school districts." (41a-42a (citing 158a-59a).) But the cited portion of the 1996 GAO report did not identify either Marriott or Aramark *as a wrongdoer*. Rather, the report's observation – merely that the two companies were large FSMCs that contract with SFAs, without any mention of rebate retention or other wrongdoing – was legally insufficient to trigger the bar. For purposes of the public disclosure bar, "identification" means identification as a wrongdoer. *Cooper*, 19 F.3d at 567 (holding that bar was not triggered where report mentioned defendant by name but did not state that defendant had engaged in wrongdoing: "This report does name BCBSF. . . . But the report does not allege that BCBSF in its capacity as a primary insurer actually engaged in wrongdoing."). Thus, the court's holding that any Respondent was "already identified" was erroneous.

Third, application of the "easily identifiable" test was incorrect for the second, fourth, fifth, and sixth reasons stated in Point I.B.1., *supra*.

Finally, the district court's reference to "industry-wide" fraud could not have constituted a holding that fraud was universal in Respondents' industry. The record evidence shows that there was public disclosure of rebate retention in *far less than half* of the industry. *See supra* at 13-14 (citing figures). Such disclosure hardly revealed *universal* fraud in Respondents' industry. Thus, the district court was defining "industry-wide" to mean something substantially less than "universal."[22] Since the "easily identifiable" test, if it applies at all, should apply only where there has been public disclosure of *universal* fraud in the relevant industry, *see supra* at 18-28, the district court erred in applying the "easily identifiable" test here.

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In sum, while one circuit has applied the "identified" test and five circuits have applied the "identifiable" test, the circuits are split 3-3 with respect to their holdings: Three hold that the "identifiable" test applies only where public disclosures showed universal fraud in the defendants' industry, and three hold that the "identifable" test applies even absent public

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[22] By contrast, the *Gear* court, which also used the phrase "industry-wide," showed that by the phrase it indeed meant "universal," as *Gear* involved an investigation of *all* of the nation's 125 medical schools. *Gear*, 436 F.3d at 728-29.

disclosure of such universality. The Petition should be granted so that this Court can both resolve the circuit conflict and correct holdings (like the Third Circuit's below) that expand the public disclosure bar beyond what the bar's plain language provides.

II. Four Circuits Applying the "Easily Identifiable" Test Have Improperly Resurrected the Repealed "Government Knowledge" Bar

Four of the five circuits applying the "easily identifiable" test (i.e., the Third, Ninth, Tenth, and D.C. Circuits) have held that "easily identifiable" means easily identifiable *by the government*. In so holding, these courts have read back into section 3730(e)(4)(A) the "government knowledge" bar, which in 1986 Congress repealed and replaced with the public disclosure bar. Accordingly, the Petition should be granted so that this Court can correct these erroneous holdings. While *Fine*, *Findley*, *Harshman*, and *Pritsker* all conditioned the applicability of the public disclosure bar on whether the *government* had sufficient information to identify the defendant, *Findley* gave the fullest explanation for that incorrect holding.[23]

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[23] *See Fine*, 70 F.3d at 571 ("[T]hese disclosures . . . sufficiently alerted the government to the likelihood that Sandia would also 'tax' nuclear waste funds in the future. . . . [The disclosures] set the government squarely on the trail of the alleged fraud without [the relator's] assistance . . . ."); *Harshman*, 197 F.3d at 1019 ("[T]he instant case is similar to [*Fine*], in that the government, as regulator and owner, presumably would have

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In *Findley*, the D.C. Circuit concluded that the prior public disclosures had placed enough information in the *government's* hands to warrant application of the public disclosure bar: "[R]elator Findley's complaint merely echoes publicly disclosed, allegedly fraudulent transactions that already enable the *government* to adequately investigate the case and to make a decision whether to prosecute . . . ." *Id.* at 688 (emphasis added). In so holding, *Findley* unjustifiably resurrected the "government knowledge" bar. That provision – the public disclosure bar's predecessor – required dismissal of a *qui tam* action that is "'based upon evidence or information in the possession of the *United States* . . . at the time such suit was brought.'" *Id.* at 680 (emphasis added) (quoting "government knowledge" bar, 31 U.S.C. § 3730(b)(4) (1982)). In 1986, as *Findley* itself recognized, Congress repealed the "government knowledge" bar and replaced it with the public disclosure bar. *Id.* at 681, 684 n.4. Yet the *Findley* court revived the "government knowledge" bar – and substituted it for the public disclosure bar – by making the public disclosure bar depend on whether the public disclosures at issue would "enable

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ready access to documents identifying those contractors. This ready access makes it highly likely that *the government could easily identify* the contractors at issue." (emphasis added)); *Pritsker*, 2009 WL 579380, at *11 ("It would be relatively easy for anyone, *including the Government*, to discern which FSMCs engaged in this practice merely by looking at their contracts with SFAs and comparing them to the RFPs." (emphasis added)) (*see* 41a). By contrast, the Seventh Circuit has held that "easily identifiable" means easily identifiable *from the public disclosures*, not *by the government*. *See Gear*, 436 F.3d at 729.

the *government* to adequately investigate the case and to make a decision whether to prosecute . . . ." *Id.* at 688 (emphasis added). The *Findley* court was led astray primarily by *Pettis ex rel. United States v. Morrison-Knudson, Co.*, 577 F.2d 668 (9th Cir. 1978), which held that the *government knowledge* bar is "triggered whenever 'the evidence and information in possession of the *United States* at the time the FCA suit was brought was sufficient to enable it to adequately investigate the case and to make a decision whether to prosecute.'" *Findley*, 105 F.3d at 684 (quoting *Pettis*, 577 F.2d at 674) (emphasis added). Whether correct or not in 1978, the *Pettis* holding was indisputably superseded by statute in 1986 with Congress' change of the bar's trigger from "government knowledge" to "public disclosure."

Findley's revival of the "government knowledge" bar was all the more inexplicable because *Findley* itself traced the legislative history demonstrating the repeal of the "government knowledge" bar and its replacement by the public disclosure bar. That history is instructive. In *United States ex rel. Marcus v. Hess*, 317 U.S. 537 (1943), this Court permitted a *qui tam* suit in which the relator's complaint was copied directly from a criminal fraud indictment. 105 F.3d at 680. To end such "parasitic" lawsuits, Congress in 1943 amended the FCA to bar jurisdiction over any *qui tam* action "'based upon evidence or information in the possession of the *United States* . . . at the time such suit was brought.'" *Id.* (quoting 1943 amendment)

(emphasis added).[24] In 1986, however, Congress changed the bar from one precluding actions based on inculpatory information in the "possession of the United States" to one precluding actions "based upon the public disclosure" of inculpatory information. *Findley* even noted the shift from a "government knowledge" bar to a "public disclosure" bar, *id.* at 681, 684 n.4, observing: "Congress thus changed the focus of the jurisdictional bar from evidence of fraud inside the government's overcrowded file cabinets to fraud already exposed in the public domain." *Id.* at 684. A key goal of this change was to remedy the "inadequacy of government FCA enforcement" and "to prod the government into action." *Id.* at 684 n.4.[25] Thus, the purpose of the public disclosure bar is still to end "parasitic" *qui tam* complaints (albeit those copied from a public disclosure rather than a document possessed by the government). But, since 1986, the purpose is also to ensure, for the benefit of the fisc, that allegations brought by a relator to the government before the filing of the *qui tam* action are not simply nullified by the combination of the "government knowledge" bar (which would preclude

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[24] *Pettis* provided the prevailing judicial gloss on the "government knowledge" bar. *See* 105 F.3d at 684.

[25] As *Findley* explained, "That purpose was not served by stopping *qui tam* suits whenever evidence or information of fraud was buried somewhere in a government file. Permitting *qui tam* suits based upon information known by the government but not the public, however, would discourage lackadaisical law enforcement." *Id.* at 684 n.4.

suit by the relator) and the inaction of government attorneys (which would prevent suit by the government).

In sum, the correct trigger for the public disclosure bar is whether the relator's *qui tam* complaint bore too close a resemblance to the public disclosure and not whether the public disclosure enabled the government to investigate and make a prosecutorial decision. By basing its holding on the *Pettis* test, however, the *Findley* court reached the opposite conclusion. The *Findley* court thereby contravened an essential purpose of the 1986 amendments to the FCA: to ensure that the bar cannot put the relator's allegations at the mercy of governmental action or inaction. Under a proper reading of the public disclosure bar, the fact that public disclosures gave the government sufficient information to investigate and decide whether to sue *must not* bar the relator's action – whereas, under *Findley*'s misreading of the bar, the same fact *must* bar the relator's action. Because four circuits have thus misread the bar, this Court should grant review and correct the misinterpretation.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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NOT PRECEDENTIAL

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 09-1975

UNITED STATES OF AMERICA, ex rel.;
ROBERT PRITSKER

v.

SODEXHO, INC.; ARAMARK CORPORATION;
COMPASS GROUP USA, doing business as
Chartwells; SODEXHO AMERICA LLC;
SODEXHO MARRIOTT MANAGEMENT, INC.;
SODEXHO MANAGEMENT, INC; ARAMARK
EDUCATIONAL SERVICES, INC.

Robert Pritsker,

Appellant

On Appeal From the United States District Court
for the Eastern District of Pennsylvania
(03-cv-6003)
District Judge: Honorable Berle M. Schiller

Argued January 15, 2010

Before: AMBRO, CHAGARES, and STAPLETON,
Circuit Judges.

(Filed: February 9, 2010)

OPINION OF THE COURT

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CHAGARES, *Circuit Judge.*

Relator Robert Pritzker [sic] appeals the District Court's dismissal of this *qui tam* action against defendants Sodexho, Inc., Sodexho America, LLC, Sodexho Marriott Management, Inc., and Sodexho Management, Inc. ("Sodexho"); ARAMARK Corporation and Aramark Educational Services, Inc. ("ARAMARK"); and Compass Group USA, Inc., doing business as Chartwells ("Chartwells"). We will affirm.

I.

Because we write solely for the benefit of the parties, we will only briefly summarize the essential facts. Pritzker [sic] filed this *qui tam* action by filing a complaint, *pro se,* under seal in the District Court for the Eastern District of Pennsylvania on October 30, 2003. He filed an amended complaint, represented by counsel, on August 1, 2007. Pritzker [sic] alleges that the defendants caused the submission of false claims in connection with the National School Lunch Program and the School Breakfast Program, in violation

of 31 U.S.C. §§ 3729(a)(1) and 3729(a)(2). These federal school programs are administered by the Food and Nutrition Service ("FNS") of the United States Department of Agrigulture [sic] ("USDA"). FNS provides grants to the relevant State Agencies ("SAs"), who in turn distribute these funds to the School Food Authorities ("SFAs") responsible for administering the federal school food programs in individual school districts. Many SFAs operate their own school food programs, but some SFAs contract with food service management companies ("FSMCs") such as the defendants to manage and operate the lunch and breakfast programs in their school districts.

Pritzker [sic] alleges that the defendants caused SFAs and SAs to certify falsely compliance with the regulations governing the National School Lunch Program and the School Breakfast Program, in two different ways. First, Pritzker [sic] alleges that the defendants retained rebates and credits they received from their suppliers, in violation of regulations requiring that costs reimbursed in cost-reimbursable contracts be net of any rebates or credits (the "rebate claims"). Second, Pritzker [sic] alleges that the defendants purchased food and supplies from higher cost national distributors who offered to pay rebates and credits rather than from lower cost regional distributors, in violation of procurement regulations requireing free and open competition (the "procurement claims").

Before Pritzker [sic] filed his complaint, several government agencies had investigated the issues underlying the rebate claims. In 1996, the General

Accounting Office published a report on the "Role and Impacts of Private Food Service Companies." Joint Appendix ("J.A.") 125-190 ("1996 GAO Report"). The 1996 GAO Report observed "[f]ood service contracts vary in their treatment of rebates and discounts received by the food service company when it purchases food for the food authorities." J.A. 132. Of the contracts reviewed for the report, 40 percent did not address rebates or discounts, 37 percent required the FSMCs to pass through rebates and discounts, and 18 percent permitted FSMCs to retain rebates and discounts. J.A. 163.

Beginning in 2001, the USDA's Office of Inspector General ("OIG") conducted a series of audits examining various issues regarding the federal school food programs, including the retention of rebates by FSMCs. This investigation culminated in an audit report published April 30, 2002 (the "April 2002 Audit Report"). J.A. 329-370. The objective of this report was "to determine whether sufficient controls existed to ensure that management companies complied with program requirements in crediting [SFAs] for the value of USDA-donated commodities and purchase discounts and rebates." J.A. 331. The report disclosed that:

> Two management companies that maintained cost-reimbursable contracts nationwide profited at the expense of 7 of the 19 [SFAs] we reviewed by retaining over $280,000 in discounts and rebates they received on purchases made for their food service operations.

> To accomplish this, the management companies amended, eliminated, or ignored terms in the requests for proposal issued by the [SFAs]. Contrary to FNS regulations, the management companies were able to include contract terms that favored them, because FNS did not mandate specific contract terms and provisions.
>
> . . .
>
> These 2 management companies contracted with over 18 percent of the 1,648 SFA's that had management contracts nationwide.

J.A. 332; *see also* J.A. 340. The results of this April 2002 Audit Report were also highlighted in a newspaper article, J.A. 363, and congressional testimony, J.A. 432.

In response to these OIG audits, FNS promulgated new regulations explicitly requiring SFAs to include contract terms prohibiting FSMC retention of rebates and other credits. *See* Procurement Requirements for the National School Lunch, School Breakfast and Special Milk Programs, 69 Fed. Reg. 78340 (Dec. 30, 2004). The proposed rules were issued in 2004, and the regulations became effective in 2007.

The District Court entered a final order dismissing the complaint on March 6, 2009. The District Court dismissed the rebate claims for lack of subject matter jurisdiction, holding that the False Claim's

Act jurisdictional bar, 31 U.S.C. § 3730(e)(4), precluded it from exercising jurisdiction.[1] The court concluded that "critical elements of the Relator's allegations, indeed, the fraud itself, were public long before Relator filed suit." J.A. 16. The "meat and potatoes of the fraud – retention of rebates despite regulations requiring those rebates to be passed through to the SFAs – was revealed" in the April 2002 Audit Report, and Pritzker [sic] "merely molds this publicly disclosed regulatory violation into a false certification theory. . . ." *Id.* The court also held that Pritzker [sic] was not an original source of the information underlying the rebate claims. The court dismissed the procurement claims for failure to state a claim under Fed. R. Civ. Proc. 12(b)(6), holding that although the procurement regulations required SFAs to engage in competitive bidding when contracting with FSMCs, these regulations did not require competitive bidding in the FSMCs' subsequent procurement of food and supplies.

Pritzker [sic] timely appealed.

II.

The District Court had jurisdiction, if at all, pursuant to 31 U.S.C. §§ 3730(b)(1) and 3732(a), and

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[1] As an alternative basis for dismissing the rebate claims, the District Court also concluded that Pritzker [sic] had failed to allege a false claim, because the regulations did not clearly prohibit the defendants' conduct until they were revised in 2007.

we have jurisdiction pursuant to 28 U.S.C. § 1291. We exercise plenary review over the District Court's dismissal of the rebate claims based on the statute's jurisdictional bar, *see, e.g., United States ex rel. Dunleavy v. County of Delaware*, 123 F.3d 734, 737 (3d Cir. 1997) (citation omitted), and over the District Court's dismissal of the procurement claims for failure to state a claim, *see, e.g., Umland v. Planco Financial Services, Inc.*, 542 F.3d 59, 63-64 (3d Cir. 2008).

III.

Pritzker's [sic] first argument on appeal is that the District Court erred by dismissing the rebate claims as barred by § 3730(e)(4). The False Claims Act bars *qui tam* suits where the fraud has been publicly disclosed in certain enumerated sources prior to the commencement of the suit, unless the relator was the original source of the information.[2] 31 U.S.C. § 3730(e)(4). Section 3730(e)(4) provides:

> (A) No court shall have jurisdiction over an action under this section based upon the public disclosure of allegations or transactions in a criminal, civil, or administrative hearing, in a congressional, administrative, or [GAO] report, hearing, audit, or investigation, or from the news media, unless the

[2] Counsel for Pritzker [sic] conceded during oral argument that Pritzker [sic] was not an "original source" for purposes of § 3730(e)(4).

> action is brought by the Attorney General or the person bringing the action is an original source of the information.
>
> (B) For purposes of this paragraph, "original source" means an individual who has direct and independent knowledge of the information on which the allegations are based and has voluntarily provided the information to the Government before filing an action under this section which is based on the information.

Id.

We hold that the District Court properly dismissed the rebate claims because the court lacked jurisdiction over these claims pursuant to § 3730(e)(4). We hereby adopt the careful and detailed analysis employed by Judge Schiller on this issue.[3]

IV.

Pritzker's [sic] second argument is that the District Court erred by dismissing the procurement claims for failure to state a claim. The "full and open competition" regulations apply only to grantees and subgrantees of federal funds, in this case SAs and

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[3] The District Court also concluded that, even if the rebate claims were not jurisdictionally barred, Pritzker [sic] failed to state a claim because he could establish that the claims submitted by SAs and SFAs were false or fraudulent. Because we conclude that the rebate claims are barred by § 3730(e)(4), we do not reach this issue.

SFAs. *See* 7 C.F.R. §§ 3016.36(a) (requiring that grantees and subgrantees follow the listed procurement standards), 3016.36(c)(1) (requiring "full and open competition" in all "procurement transactions"). Pritzker [sic] acknowledges that FSMCs are not directly covered by these regulations but argues that since the defendants procured food and supplies on behalf of SFAs, the defendants' failure to employ competitive bidding caused the SFAs to falsely certify compliance with the regulations. Pritzker [sic] cannot, however, identify any regulation requiring competitive bidding on the part of FSMCs. As the National School Lunch Program regulations make clear, an SFA is required to "[a]dhere to the procurement standards . . . *when contracting with the food service management company*." 7 C.F.R. § 210.16(a)(1) (emphasis added). The SFAs, as subgrantees, are required to conduct competitive bidding when selecting an FSMC, *see* 7 C.F.R. § 3016.36(c)(1), but Pritzker [sic] cannot identify any authority suggesting that these procurement regulations reach any deeper into the supply chain. We agree with the District Court that Pritzker [sic] has failed to state a claim with respect to the procurement claims.

V.

For the foregoing reasons, we will affirm the judgment of the District Court.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 09-1975

UNITED STATES OF AMERICA, ex rel.;
ROBERT PRITSKER

v.

SODEXHO, INC.; ARAMARK CORPORATION;
COMPASS GROUP USA, doing business as
Chartwells; SODEXHO AMERICA LLC;
SODEXHO MARRIOTT MANAGEMENT, INC.;
SODEXHO MANAGEMENT, INC; ARAMARK
EDUCATIONAL SERVICES, INC.

Robert Pritsker,

Appellant

On Appeal From the United States District Court
for the Eastern District of Pennsylvania
(03-cv-06003)
District Judge: Honorable Berle M. Schiller

Argued January 15, 2010

Before: AMBRO, CHAGARES, and STAPLETON,
Circuit Judges.

(Filed: February 9, 2010)

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the Eastern District of Pennsylvania and was argued on January 15, 2010.

On consideration whereof, it is now hereby

ADJUDGED and ORDERED by this Court that the judgment of the United States District Court for the Eastern District of Pennsylvania entered March 6, 2009, is hereby AFFIRMED, all in accordance with the opinion of this Court.

Costs shall be taxed against the appellant.

Attest:

/s/ Marcia M. Waldron
Clerk

DATED: February 9, 2010

[Seal]

Certified as a true copy and issued in lieu of a formal mandate on April 6, 2010

Teste: /s/ Marcia M. Waldron
Clerk, U.S. Court of Appeals for the Third Circuit

Costs taxed in favor of Appellees Sodexho America LLC, Sodexho Marriott Management Inc., and Sodexho Management, Inc. as follows:

Brief	$199.60
Appendix	$132.00
Sales Tax (5%)	$ 16.58
Total	$348.18

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT
OF PENNSYLVANIA

UNITED STATES, **Plaintiff,**	:	**CIVIL ACTION**
ROBERT PRITSKER, **Relator,**	:	
v.	:	
SODEXHO, INC., et al., **Defendants.**	:	**No. 03-6003**

MEMORANDUM AND ORDER

Schiller, J. **March 6, 2009**

This case concerns alleged fraud in the school lunch room. In order to understand the allegations in this case, it is important to understand the players and agencies involved. For the reader's convenience, the following is key of acronyms used throughout this opinion:

Acronym	Definition
FNS	Food and Nutrition Service
FSMC	Food Service Management Company
GAO	Government Accountability Office (previously known as the General Accounting Office)
NSLP	National School Lunch Program

OIG	Here, the USDA Office of Inspector General
OMB	Office of Management and Budget
RFP	Request for Proposal
SA	State Agency
SFA	School Food Authority
USDA	United States Department of Agriculture

Relator Robert Pritsker brings this *qui tam* action on behalf of the United States against Defendants Sodexho, Inc.; Sodexho America, LLC; Sodexho Marriott Management, Inc. (collectively "Sodexo"); Aramark Corporation; Aramark Educational Services, Inc. (collectively "Aramark"); and Compass Group, USA, Inc. d/b/a Chartwells ("Chartwells"). The Defendants are Food Service Management Companies ("FSMCs") that manage food services for local School Food Authorities ("SFAs") participating in the federally-funded National School Lunch Program ("NSLP") and School Breakfast Program ("SBP"). Relator alleges that Defendants violated the False Claims Act ("FCA") by failing to pass rebates, discounts and credits through to the SFAs, thereby causing the SFAs and overseeing State Agencies ("SAs") to falsely certify that their programs complied with applicable federal regulations. Relator also alleges that Defendants failed to comply with federal procurement regulations, causing SFAs and SAs to

falsely certify compliance with those regulations. Currently before the Court are Defendants' motions to dismiss for lack of subject matter jurisdiction pursuant to the FCA's jurisdictional bar, 31 U.S.C. § 3730(e)(4), and for failure to state a claim. For the following reasons, Defendants' motions are granted.

I. BACKGROUND

A. Administration of the NSLP and SBP

The NSLP and SBP are federally-funded entitlement grant programs that provide cash and United States Department of Agriculture ("USDA") commodities to non-profit school food services. The USDA administers the NSLP and SBP through the Food and Nutrition Service ("FNS"). 7 C.F.R. §§ 210.3(a), 220.3(a) (2009). FNS contracts with SAs, which contract with local SFAs, which, in turn, implement the federal programs. Both FNS's contracts with SAs and SA's contracts with SFAs require the parties to abide by applicable federal regulations. (Clark-Weintraub Decl. Ex. 1 [FNS contract with Conn. Dep't of Educ.] & Ex. 2 [Conn. Dep't of Educ. form contract with SFAs].) To obtain reimbursement from the federal government, SFAs must certify to SAs the number of meals served. Pursuant to these reimbursement requests, FNS reimburses SFAs, through SAs, on a cost-per-meal basis.[1] *See* 7 C.F.R. §§ 210.7, 210.8,

[1] Relator does not allege that Defendants misrepresented the number of meals served.

220.11. The SFA representative who signs the certification must attest that the claim is correct and supported by available records and that the claim is made in accordance with the terms of existing agreements. *Id.* § 210.8(c); (Clark-Weintraub Decl. Ex. 4 [Claim Reimbursement Form].)

Federal regulations permit SFAs to contract with FSMCs to manage food service operations and purchase food products on behalf of the SFA. 7 C.F.R. § 210.16. SFAs solicit bids from FSMCs by issuing a request for proposal ("RFP"), which specifies the contract requirements. When the relationship is governed by a cost-reimbursable contract, as is true here, the FSMC purchases food on the SFA's behalf and submits the invoices to the SFA for repayment from the nonprofit school food service account.[2]

The federal regulations governing NSLP and SBP require SAs and SFAs, as grantees and subgrantees of federal funds, to abide by the federal procurement regulations at 7 C.F.R. Parts 3016 and Part 3019 "concerning the procurement of all goods and services with non-profit school food service account funds." 7 C.F.R. §§ 210.21(a) (governing NSLP), 220.16(a) (governing SBP). Part 3016 requires grantees and subgrantees of federal funds, like

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[2] A nonprofit school food service account is a "restricted account in which all of the revenue from all food service operations conducted by the [SFA] principally for the benefit of school children is retained and is used only for the operation or improvement of the nonprofit school food service." 7 C.F.R. § 210.2.

SAs and SFAs, to conduct procurement transactions "in a manner providing full and open competition." *Id.* § 3016.36(c). The regulations at that part pertaining to financial administration limit use of federal funds to "[t]he allowable costs of the grantees [and] subgrantees" and direct state and local governments to the principles of Office of Management and Budget ("OMB") Circular A-87 to determine which costs are allowable. *Id.* § 3016.22. OMB Circular A-87, codified at 2 C.F.R. Part 225, requires that to be allowable, costs paid from federal funds "[b]e the net of all applicable credits." 2 C.F.R. Part 225 Appx. A § (C)(1)(i). Applicable credits are "those receipts or reduction of expenditure-type transactions that offset or reduce expense items allocable to Federal awards as direct or indirect costs," such as "[p]urchase discounts, rebates or allowances, recoveries or indemnities on losses, insurance refunds or rebates, and adjustments of overpayments or erroneous charges." *Id.* § (C)(4)(a).

B. OIG Investigates FSMC Rebate Retention

In August, 1996 GAO issued a report that broadly reviewed the use of private food establishments by schools participating in federal programs. It found, among other things, "that some FSMC contracts contain provisions allowing FSMCs to receive some of the rebates and discounts obtained from vendors." *GAO Report, School Lunch Program: Role and Impacts of Private Food Service Companies* 37

(1996). The USDA Office of Inspector General ("OIG") subsequently initiated regional audits to investigate the extent to which FSMCs retained rebates, discounts and credits instead of passing them through to the SFAs. *See* Southeast Region Audit, OIG, USDA, Report No. 27601-10-At, *Food and Nutrition Service National School Lunch Program Controls Over Food Service Management Companies, South Carolina School Years 1997 Through 1999* 1 (Feb. 2001) ("Prior [OIG] audits and investigations disclosed that FSMC does not always pass on to SFA the full value of . . . discounts and rebates on commercial purchases."); Southwest Region Audit, OIG, USDA, Report No. 27601-9-Te, *Food and Nutrition Service National School Lunch Program Food Service Management Companies* (Mar.2001) (auditing New Mexico FSMCs); Western Region Audit, OIG, USDA, Report No. 27099-15-SF, *Food and Nutrition Service National School Lunch Program Food Service Management Companies* (Apr.2001) (auditing Washington State FSMC).

In April 2002, OIG published an audit report compiling six regional investigations of the NSLP as operated by FSMCs nationwide. Midwest Region Audit, OIG, USDA, Report No. 27601-0027-CH, *Food and Nutrition Service National School Lunch Program Food Service Management Companies* (Apr. 2002) [hereinafter April 2002 Audit]. The audit's stated objectives were to "determine whether sufficient controls exist[ed] to ensure that (1) food service management companies credit SFA's for the

full value of . . . purchase discounts and rebate[s] as applicable; and (2) that management companies and SFA's administered the NSLP in accordance with applicable laws, regulations, and FNS guidelines." *Id.* at 2.

The audit, which assumed that FSMCs engaged in cost-reimbursable contracts were required to pass discounts or rebates through to SFAs, concluded that "the purchase discounts . . . were used to enrich the management companies instead of benefiting [*sic*] the SFA's as required by Federal regulations." *Id.* at 5 (footnote omitted). Specifically, the audit revealed that:

> Two management companies that maintained cost-reimbursable contracts nationwide profited at the expense of 7 of the 19 SFA's we reviewed by retaining over $280,000 in discounts and rebates they received on purchases made for their food service operations. To accomplish this, the management companies amended, eliminated, or ignored terms included in the requests for proposal issued by the SFA's.

Id. at ii. OIG's conclusions relied on the premise that OMB Circular A-87's allowable cost principles required FSMCs to bill costs net of all applicable credits. *Id.* at 11, 11 n.5.

OIG recommended that states require new contracts with FSMCs to expressly declare that the FSMC will pass rebates and other discounts through to the SFA. *Id.* at iii. It also recommended that FNS

issue a statement providing guidance to SAs so as to ensure compliance with regulations mandating the pass through of rebates. *Id.* at 14-15. A June 2002 news article reported on the audit, publicizing its findings to the food service industry. Paul King, *USDA Report Contractors Skimmed Millions From Lax Education Clients*, Nation's Restaurant News (June 3, 2002), *available at*, http://findarticles.com/p/articles/mi_mi3190/is_22_36/ai_86762976/print?tag=artBody;col1 (last visited Feb. 26, 2009).

C. FNS determines that OMB Circular A-87 does not apply to cost-reimbursable contracts between FSMCs and SFAs

Shortly after the large-scale audit was conducted, FNS changed its position regarding the applicability of OMB Circular A-87 to cost-reimbursable contracts between SFAs and FSMCs. On November 26, 2002, Stanley Garnett, Director of the Child Nutrition Division of FNS,[3] issued a management alert to the Regional Directors of Child Nutrition Programs announcing that:

> Recently, we met with officials of [OMB] concerning the applicability of OMB circulars to contracts between [SFAs] and [FSMCs]. OMB has determined that its circular

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[3] The Child Nutrition Division is the arm of FNS responsible for administering the NSLP and SBP. 7 C.F.R. §§ 210.3(a), 220.3(a).

> requirements for net costs, i.e., allowable costs must be net of all credits, discounts and rebates, do not apply to the nonprofit school food service account for expenditures resulting from the contracts between the SFA and FSMC.

(Aramark Mot. Ex. H [Nov. 26, 2002 Management Alert]). Accordingly, explicit contract terms were necessary to require FSMCs to pass through rebates to SFAs. However, FNS "strongly encouraged" SFAs to include such provisions in their cost-reimbursable contracts with FSMCs. *(Id.)*

FNS reiterated this position in a December 17, 2002 memo:

> This memorandum is intended to rescind the prohibition against FSMCs receiving the value of credits, discounts and rebates under certain conditions. The OMB determined its circular requirements for net costs, i.e., allowable costs must be net of all credits discounts and rebates, do not apply to the nonprofit school food service account for expenditures resulting from cost reimbursement contracts between the SFAs and FSMCs.
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> In light of this interpretation [FNS] strongly encourages the inclusion of provisions in all cost reimbursable contracts that require FSMCs only charge allowable costs that are net of credits, discounts, and rebates received by the FSMC. Please realize that SFAs failing to include such a provision in its

> contracts may be liable to the FSMC for payment of costs in excess of the actual net costs incurred by the FSMC. Since the OMB made it clear that State agencies and SFAs can impose compliance with net cost requirements through contractual terms, FNS will fully support State agencies and SFAs that elect to require contract terms that protect the financial integrity of the program.

(Clark Weintraub Decl. Ex. 7 [Dec. 17, 2002 Rankin Memo].) FNS subsequently restated this position three times. (Sodexo's Mot. to Dismiss Furey Aff. Ex. 12 [Jan. 15, 2003 Memo] ("OMB Circular requirements stating that allowable costs must be net of all credits, discounts and rebates, do ***NOT*** apply to the nonprofit school food service account for expenditures resulting from the contracts between the school food authority (SFA) and the FSMC."); Ex. 13 [May 20, 2003 Letter from Dir. of Child Nutrition Div.] at Question 5 ("FNS strongly encourages, but does not require, that all cost reimbursable contracts include provisions to ensure SFAs are only charged net, allowable costs."); Ex. 14 [July 9, 2004 Letter from Dir. of Child Nutrition Div.] (declaring that position expressed in May 20, 2003 letter "remains unchanged").

D. FNS Takes Regulatory Action

On July 9, 2003, Phyllis K. Fong, Inspector General of the USDA testified before the United States House of Representatives Committee on the

Budget regarding fraud, waste and abuse in mandatory spending programs. (Furey Aff. Ex. 15 [Fong Testimony].) During her testimony, Fong identified "local school food authority contracts with food service providers" as susceptible to fraud, waste or abuse. (*Id.* at 20.) She testified that:

> OIG is working with FNS to address cost reductions in the form of contract discounts, rebates, and allowances. Federal cost principles require that such benefits accrue to the program. However, [OMB] has recently determined that Federal cost principles do not apply to local contracts with [FSMCs]. FNS is pursuing regulatory action to address this problem.

(*Id.* at 20.)

On December 30, 2004, FNS issued a proposed rule that sought to implement changes to NSLP and SBP regulations. *Procurement Requirements for the National School Lunch, School Breakfast and Special Milk Programs*, 69 Fed. Reg. 78340 (proposed Dec. 30, 2004). The rule intended to "clarify that only costs resulting from cost reimbursable contracts or cost reimbursable contract provisions that meet applicable cost allowability requirements are allowable nonprofit school food service account expenditures." It further sought to "prohibit contract terms that allow payments from the nonprofit school food service account in excess of the contractor's actual net allowable costs." *Id.* at 78342. The rule was partially motivated by the findings of OIG's April 2002 audit

regarding FSMCs' retention of credits, discounts and rebates. *Id.* at 78341. After a comment period, the changes were finalized and made effective as of November 30, 2007. *Procurement Requirements for the National School Lunch, School Breakfast and Special Milk Programs*, 72 Fed. Reg. 61479-01 (Oct. 31, 2007).

Despite this proposed regulatory action, OIG, which disagreed with FNS's position on Circular A-87's applicability, continued to investigate rebate-related abuses. *See* Great Plains Region Audit, OIG, USDA, Report No. 27601-15-KC, *Food and Nutrition Service National School Lunch Program Cost-Reimbursable Contracts with a Food Service Management Company* 8 (Dec. 2005) [hereinafter "December 2005 Audit"] (noting that, despite FNS's position, "[w]e continue to believe that the costs billed by the company to its SFAs with cost-reimbursable contracts should be the net costs incurred by the company"). A December 2005 audit investigated Defendant Chartwells to determine whether it "passed on cost savings on food purchases to SFAs when required to do so by contract" and determined, from a review of 106 contracts, that Chartwells retained at least $1.3 million in discounts, rebates and incentives.[4] *Id.* at i.

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[4] Although the December 2005 audit did not expressly name Chartwells, it references a March 2002 audit of Chartwells, noting that two audits investigated the same FSMC. December 2005 Audit at 4 n.10; Great Plains Region Audit, OIG, USDA, Report No. 27601-13-KC, *Food and Nutrition Service*

(Continued on following page)

E. Relator's allegations

Relator filed his Complaint on October 30, 2003. He alleged that, since 1993, Defendants have failed to credit SFAs with rebates, discounts and allowances they received from food manufacturers and national distributors, thereby causing SFAs to falsely certify compliance with applicable federal regulations that prohibit SFAs from paying costs that are not net of rebates. He also asserted that, by including provisions in their cost reimbursable contracts allowing them to keep such rebates, Defendants breached the requirements of OMB Circular A-87 and that their contracts were, in essence, "cost-plus-a-percentage-of-cost" contracts, which are prohibited by federal regulations. *See* 7 C.F.R. § 210.16(c).

The United States moved to extend the seal on this action several times to investigate Relator's allegations. *See* 31 U.S.C. § 3730(b)(3). In March 2005, however, the United States opted not to intervene. The Court subsequently extended the seal, on Relator's request, while Relator retained counsel; the seal was again extended once new counsel was retained so that Relator could amend his Complaint.

On August 31, 2007, Relator filed an Amended Complaint. As in his initial Complaint, Relator accused Defendants of causing SFAs to falsely certify

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National School Lunch Program Chartwells Food Service Management Company (Mar. 2002) [hereinafter March Chartwells Audit]

compliance with federal regulations by failing to credit SFAs with rebates, discounts and allowances that Defendants received from food manufacturers and national distributors. For the first time, Relator also alleged that Defendants' use of national distributors (who gave them rebates), instead of seeking competitive bids from local distributors (who charge less for the same goods), caused SFAs to falsely certify compliance with federal procurement regulations requiring procurement in a manner "providing full and open competition." *See* 7 C.F.R. § 3016.36(c). The fifty-three-page Amended Complaint quotes extensively from several of Defendants' contracts with SFAs and from RFPs issued by those SFAs, and identifies specific invoices that Relator alleges will prove his theory. The Amended Complaint baldly asserts that it "is not based on any public disclosure of information" and that to the extent any of his allegations have been publicly disclosed, "Relator has direct and independent knowledge of the information on which the allegations are based." (Am. Compl. ¶ 7.)

The Court extended the seal for another sixty days to permit the Government to assess the allegations of the Amended Complaint. The Government did not seek to intervene nor to extend the seal. Accordingly, the Court lifted the seal so that Plaintiff could serve the Defendants. After Defendants were served, they filed the instant motions to dismiss, predominately arguing that the FCA's jurisdictional bar, 31 U.S.C. § 3730(e)(4), divests this Court of

jurisdiction and that Plaintiff has failed to state a claim because the regulations upon which he relies do not apply to FSMCs.

II. STANDARDS OF REVIEW

Challenges to subject matter jurisdiction, pursuant to Federal Rule of Civil Procedure 12(b)(1), may be facial or factual. *Medina v. City of Phila.*, Civ. A. No. 04-5698, 2005 WL 1124178, at *2 (E.D. Pa. May 9, 2005) (citing *Mortensen v. First Fed. Sav. & Loan Ass'n*, 549 F.2d 884, 891 (3d Cir. 1977)), *aff'd*, 219 Fed. Appx. 169 (3d Cir. 2007). "In a facial attack, a defendant argues that the plaintiff did not properly plead jurisdiction . . . [whereas] a 'factual' attack asserts that jurisdiction is lacking on the basis of facts outside of the pleadings." *Smolow v. Hafer*, 353 F. Supp. 2d 561, 566 (E.D. Pa. 2005). When a defendant brings a factual attack, as Defendants do here, the Court may consider matters outside the pleadings when determining its jurisdiction. *See United States ex rel. Atkinson v. Pa. Shipbuilding Co.*, 473 F.3d 506, 514 (3d Cir. 2007) (concluding that challenge to jurisdiction pursuant to Section 3730(e)(4) is factual). A relator "bears the burden of alleging facts essential to show jurisdiction under the False Claims Act as well as supporting those allegations with competent proof." *United States ex rel. Grynberg v. Praxair, Inc.*, 389 F.3d 1038, 1048 (10th Cir. 2004) (internal quotations omitted).

A court reviewing a motion to dismiss, pursuant to Rule 12(b)(6), should accept the complaint's allegations as true, read those allegations in the light most favorable to the plaintiff, and determine whether a reasonable reading indicates that relief may be warranted. *Umland v. PLANCO Fin. Servs., Inc.*, 542 F.3d 59, 64 (3d Cir. 2008). Although the federal rules impose no probability requirement at the pleading stage, a plaintiff must present "enough facts to raise a reasonable expectation that discovery will reveal evidence of the necessary element[s]" of a cause of action. *Phillips v. County of Allegheny*, 515 F.3d 224, 234 (3d Cir. 2007); *see also Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 127 S. Ct. 1955, 1965 (2007) ("Factual allegations [in a complaint] must be enough to raise a right to relief above the speculative level."). Simply reciting the elements will not suffice. *Phillips*, 515 F.3d at 231. When faced with a motion to dismiss for failure to state a claim, courts may consider the allegations in the complaint, exhibits attached to the complaint, matters of public record, and documents that form the basis of a claim. *Lum v. Bank of Am.*, 361 F.3d 217, 222 n.3 (3d Cir. 2004). Additionally, a court may consider "court files, records, and letters of official actions or decisions of government agencies and administrative bodies when considering a Rule 12(b)(6) motion." *Fed. Elec. Comm'n v. Arlen Specter '96*, 150 F. Supp. 2d 797, 803 n.5 (E.D. Pa. 2001) (internal quotations omitted).

III. DISCUSSION

A. The Court Lacks Jurisdiction Over Relator's Rebate-Related Allegations

Before bringing a claim under the FCA, a relator must give the Government the option to intervene and take over the action. 31 U.S.C. § 3730(b) (2008). If the Government declines to intervene, a relator may proceed subject to the FCA's jurisdictional bar, 31 U.S.C. § 3730(e)(4). That provision divests a district court of jurisdiction when: "(1) there was a 'public disclosure'; (2) 'in a criminal, civil, or administrative hearing, in a congressional, administrative or [General] Accounting Office report, hearing, audit, or investigation, or from the news media'; (3) of 'allegations or transactions' of the fraud; (4) that the relator's action was 'based upon'; and (5) the relator was not an 'original source' of the information." *United States ex. rel. Pranich v. Sorgnard*, 396 F.3d 326, 332 (3d Cir. 2005).

1. Relator's rebate-related allegations are based upon publicly disclosed allegations or transactions, but his procurement-related allegations are not

The first inquiry in the jurisdictional analysis is whether Plaintiff's claim "is based on publicly disclosed allegations or transactions." *Atkinson*, 473 F.3d at 519. This inquiry proceeds in two steps. The Court initially determines "whether the information was disclosed via one of the sources listed in § 3730(e)(4)(A)"

and subsequently determines "whether the relator's complaint is based on those disclosures." *Id.*; *see also United States ex rel. Dunleavy*, 123 F.3d 734, 744 (3d Cir. 1997). "An 'allegation' of fraud is 'a conclusory statement implying the existence of provable supporting facts,'" while a "fraudulent 'transaction' . . . is one that discloses the 'critical elements' of fraud." *United States ex rel. Waris v. Staff Builders, Inc.*, Civ. A. No. 96-1969, 1999 WL 788766 (E.D. Pa. Oct. 4, 1999) (quoting *United States ex rel. Springfield Terminal Ry. Co. v. Quinn*, 14 F.3d 645, 653-54 (D.C. Cir. 1994)). A relator's allegations are "based upon" public disclosures for purposes of the jurisdictional bar if they are "supported by" or "substantially similar to" publicly disclosed allegations or transactions, even if they are not actually derived from those disclosures. *Pranich*, 396 F.3d at 334.

The Third Circuit uses an algebraic formula to determine when publicly disclosed information triggers the jurisdictional bar:

> [I]f X + Y = Z, Z represents the allegation of fraud and X and Y represent its essential elements. In order to disclose the fraudulent transaction publicly, the combination of X and Y must be revealed, from which readers or listeners may infer Z, i.e., the conclusion that fraud has been committed.

Dunleavy, 123 F.3d at 741 (quoting *Springfield Terminal*, 14 F.3d at 654 (alteration in original). The X in this formula represents the misrepresented state of facts, the Y represents the true state of facts and

the Z represents the alleged fraud. *Id.* Accordingly, "if either Z (fraud) or both X (misrepresented facts) and Y (true facts) are disclosed by way of a listed source, then a relator is barred from bringing suit under § 3730(e)(4)(A) unless he is an original source." *Atkinson*, 473 F.3d at 519; *see also United States ex rel. Mistick v. Housing Auth. of Pittsburgh*, 186 F.3d 376, 388 (3d Cir. 1999) ("hold[ing] that a qui tam action is 'based upon' a qualifying disclosure if the disclosure sets out either the allegations advanced in the qui tam action or all of the essential elements of the qui tam action's claims").

Defendants argue that Relator's allegations were publicly disclosed by several OIG audits that investigated FSMCs' retention of rebates and concluded that FSMCs were retaining rebates instead of passing them through to SFAs. Mainly, Defendants rely on the April 2002 audit which disclosed that FSMCs were retaining rebates by amending, deleting or ignoring contrary RFP terms, thereby circumventing the principles of OMB Circular A-87. Additionally, Sodexo and Aramark point out that GAO was aware of this common industry practice as early as 1996.

Relator concedes that the Government, as revealed by the several audits on the subject, was well aware that FSMCs were retaining rebates. (Relator's Mem. of Law in Opp'n to Defs.' Mots. to Dismiss [hereinafter "Relator's Opp'n"] at 12.) The GAO and OIG audits clearly represent Section 3730(e)(4) sources capable of publicly disclosing Relator's allegations disclosures. *See* 31 U.S.C. § 3730(e)(4) (listing

"congressional, administrative or [General] Accounting Office report[s], hearing[s], audit[s], or investigation[s]" as sources that, if they disclose a relator's allegations of fraud, could bar a *qui tam* action); *Dunleavy*, 123 F.3d at 745 (administrative reports in the context of Section 3730(e)(4) refer to "administrative reports that originate with the federal government"). Nonetheless, Relator asserts that none of the sources identified by Defendants disclose his allegations, because they do not disclose that Defendants were causing the submission of false claims. In this vein, Relator argues that the audits' publication of the *information* that FSMCs were retaining rebates does not disclose the *allegation* that FSMCs, by retaining rebates, were causing SFAs to file false claims.

Although there exists a distinction between public information and publicly disclosed allegations, *see Dunleavy*, 123 F.3d at 740, Relator's argument fails because the April 2002 audit publicizes the critical elements of the fraud alleged in this case. The April 2002 audit investigated eight management companies, operating in seven states, for purposes of "determin[ing] whether sufficient controls exist[ed] to ensure that (1) food service management companies credit SFA's for the full value of . . . purchase discounts and rebate[s] as applicable; and (2) that management companies and SFA's administered the NSLP in accordance with applicable laws, regulations, and FNS guidelines." (April 2002 Audit at 2).

The audit described its findings as to FSMCs using cost-reimbursable contracts as follows:

> Two management companies that maintained cost-reimbursable contracts nationwide profited at the expense of 7 of the 19 SFA's we reviewed by retaining over $280,000 in discounts and rebates they received on purchases made for their food service operations. To accomplish this, the management companies amended, eliminated, or ignored terms included in the requests for proposal issued by the SFA's.

Id. at ii. Not only does the audit reveal that FSMCs were retaining rebates instead of passing them through to SFAs, but it describes the exact theory of fraud identified by Relator in his Amended Complaint – that FSMCs were editing out, replacing or ignoring RFP terms that would have required them to pass through rebates so that they could, instead, retain rebates in violation of Federal regulations. *Compare id.* at 11 ("The management companies were able to retain these benefits by amending, eliminating, or ignoring terms included in the RFP's issued by the SFA's that would have required them to pass through any discounts or rebates for purchases made on the SFA's behalf."); *id.* at 5 (finding that some FSMCs "insert[ed] contract provisions that were contrary to Federal regulations . . . which essentially allowed management companies to retain benefits that should have accrued to the SFAs' food service programs") *with* (Am. Compl. ¶ 26 ("[A]lthough Federal regulations required SFAs' purchases to be net of all

rebates, discounts and allowances and Requests for Proposal ("RFPs") issued by SFAs and received and reviewed by Defendants made this clear, Defendants later excluded this language from their contracts and instead inserted provisions permitting Defendants to retain rebates, discounts and allowances received from national distributors and food manufacturers.")) These findings were further broadcast by a news article (a Section 3730(e)(4)(A) enumerated source) reporting on the audit. *See USDA Report Contractors Skimmed Millions From Lax Education Clients*, *supra*.

Accordingly, the critical elements of Relator's allegations, indeed, the fraud itself, were public long before Relator filed suit. That the report is silent on false certifications is irrelevant because Relator's allegations need only be substantially similar, not identical, to those disclosed publicly. The meat and potatoes of the fraud – retention of rebates despite regulations requiring those rebates to be passed through to the SFAs – was revealed by the April 2002 audit. Relator merely molds this publicly disclosed regulatory violation into a false certification theory so as to state a claim under the FCA and then argues that the audit does not disclose his allegations because it is not phrased in the manner articulated in his Amended Complaint. Relator cannot circumvent the FCA's jurisdictional bar in such a manner. *See United States ex rel. Fine v. Sandia Corp.*, 70 F.3d 568, 572 (10th Cir. 1995) (rejecting relator's argument that GAO report identifying industry practice and

corresponding possible regulatory violation did not publicly disclose allegation because report did not identify FCA violation), *see also United States ex rel. Findley v. FPC-Boron Employees' Club*, 105 F.3d 675, 688 (D.C. Cir. 1997) ("A relator's ability to recognize the legal consequences of a publicly disclosed fraudulent transaction does not alter the fact that the material elements of the violation already have been publicly disclosed."). Indeed, the FCA's jurisdictional bar would be rendered meaningless if a relator could bypass public disclosures through the semantic legerdemain of recasting disclosed regulatory violations in false claims language.

Furthermore, this case is distinguishable from *Dunleavy*, on which Relator relies. In that case, Dunleavy, a former consultant to Delaware County, sued the County for violations of the FCA. The County, which used Department of Housing and Urban Development ("HUD") funds to acquire certain land for purposes of constructing a highway, was required to abide by HUD regulations governing permissible uses of the money. The County sold some of the land, but neither disclosed the sale proceeds in a Grantee Performance Report submitted to HUD nor returned the sales proceeds to HUD. The Third Circuit concluded that newspaper articles, a pretrial memorandum in an unrelated litigation and certain financial audits did not disclose the relator's allegations. Although these sources disclosed the county's receipt of the sale proceeds and obligation to repay those proceeds to the Federal Government (the actual

facts), they did not disclose the County's failure to report to the Federal Government that the proceeds were in the County's possession (the misrepresented facts). In contrast, a grantee performance report prepared by the county and submitted to HUD during the year in which the county would have been obligated to repay the funds did disclose the County's failure to repay, as those funds were omitted. However, because this report did not qualify as an enumerated source under Section 3730(e)(4), it did not preclude Dunleavy from pursuing his claim.

Unlike *Dunleavy*, in which the County's actual failure to pay the proceeds back to the federal government was not disclosed by an enumerated source, the critical elements of Relator's allegations in this case are all revealed by the OIG audit, a Section 3730(e)(4) enumerated source. The audit discloses that: (1) RFP terms and federal regulations obligated FSMCs to pass rebates through to SFAs; (2) Defendants adopted contract terms expressly allowing them to retain rebates or ignored RFP terms to the contrary; and (3) Defendants actually retained rebates, consequently violating the regulations' prohibitions. There is no piece of the puzzle in this case that has not been publicly disclosed by an enumerated source.

Relator's next argument is that the public disclosures identified by Defendants cannot trigger the FCA's jurisdictional bar because they failed to specifically identify Defendants as among the FSMCs who engaged in the offending practices. Contrary to

Relator's assertion, public disclosures of industry-wide fraud may bar *qui tam* actions against the defendants who engaged in those fraudulent practices even though the disclosures do not specifically identify those engaged in the fraud. In *United States ex rel. Findley v. FPC-Boron Employees' Club*, 105 F.3d 675 (D.C. Cir. 1997), the relators alleged that government employees' clubs earning revenue from vending services on federal property violated the FCA by retaining money owed to the government and using that money for social events. The D.C. Circuit rejected the relators' argument that they were blowing the whistle on specific fraud despite public disclosures identifying general fraud and concluded that the FCA's jurisdictional bar applied. The court explained that "[e]ach of the public disclosures [considered by the Court] raise[d] the specter of 'foul play' by acknowledging the questionable legality of permitting federal employees to use federal facilities for the provision of vending services and retaining revenue from such services." *Id.* at 688. Accordingly, even though none of the disclosures specifically referenced the defendants, those actors potentially engaged in the questionable practice had in essence been identified given the public disclosures. Since the relators' complaint merely "repeat[ed] what the public already knows and add[ed] only the identity of particular employees' clubs engaged in the questionable and previously documented generic practice," his claims were based upon publicly disclosed transactions. *See also United States ex rel Gear v. Emergency Med. Assocs. of Illinois, Inc.*, 436 F.3d 726, 729

(7th Cir. 2006) ("We are unpersuaded by an argument that for there to be public disclosure, the specific defendants named in the lawsuit must have been identified in the public records."); *Fine*, 70 F.3d 568, 571 (10th Cir. 1995) (GAO report that disclosed questionable practice among laboratories contracting with Department of Energy and subsequent congressional hearing barred *qui tam* action even though defendant not specifically mentioned because disclosures "set the government squarely on the trail of the alleged fraud without [relator's] assistance, [and thus] it would be contrary to the purposes of the FCA to exercise jurisdiction over his claim").

In contrast, the Eleventh Circuit in *United States ex rel. Cooper v. Blue Cross and Blue Shield of Florida, Inc.*, 19 F.3d 562 (11th Cir. 1994), found that jurisdiction existed over a relator's claims despite public disclosures of general, industry-wide fraud. The relator was a "working aged," who, by virtue of his age and federal employment, qualified for both Medicare benefits and the Federal Employees Health Benefits Program, which was administered by the defendant. Medicare Secondary Payer ("MSP") laws required the defendant to pay the relator's medical bills before sending them to Medicare. However, when the relator submitted a claim to the defendant, the defendant would instruct him to first submit the claim to Medicare. Accordingly, the relator brought a *qui tam* action alleging that defendant committed Medicare Secondary fraud. The defendant invoked the jurisdictional bar and identified five potential

disclosures, many of which revealed MSP fraud throughout the insurance industry, but did not specifically identify the defendant. The Eleventh Circuit held that "[t]he allegations of widespread MSP fraud made in sources in which [defendant] was not specifically named or otherwise directly identified [were] insufficient to trigger the jurisdictional bar." *Id.* at 566. The decision was motivated by the concern that the Government often "has difficulty identifying all of the individual actors engaged in [general] fraudulent activity." *Id.* at 566; *see also United States ex rel. Friedman v. Rite Aid Corp.*, 152 F. Supp. 2d 766, 769-70 (E.D. Pa. 2001) (*qui tam* action against Rite Aid for submitting false statement to government for sale of prescription drugs was not based on newspaper articles about large pharmacies engaged in the practice where none of the articles specifically mentioned Rite Aid).

These cases establish that when minimal effort is required to determine specific perpetrators from public disclosures of general fraud, or when the disclosed fraud could only be attributed to an ascertainable number of possible perpetrators, jurisdiction will not lie. In contrast, when the fraud occurs on a transactional level and individual perpetrators are difficult to discern, the FCA's jurisdictional bar is not triggered. These rules further the jurisdictional bar's dual purposes of encouraging putative relators to file suits that the Government is incapable of bringing on its own while preventing parasitic suits that merely

identify obvious perpetrators of generic fraud that has already been publicized.

Here, public disclosures revealed that FSMCs nationwide were altering RFP terms in order to retain rebates. It would be relatively easy for anyone, including the Government, to discern which FSMCs engaged in this practice merely by looking at their contracts with SFAs and comparing them to the RFPs. Indeed, this appears to be exactly what Relator did in constructing his Amended Complaint. Furthermore, it is clear from the April 2002 audit that the Government was already aware that FSMCs were ignoring contract terms requiring the pass through of rebates and was therefore conducting investigations of FSMCs, including Chartwells.[6] *See* December 2005 Audit. Furthermore, the 1996 GAO report, which first observed that some FSMCs used contract terms to enable their retention of rebates, specifically mentioned Marriott, Sodexo's predecessor, and Aramark

[6] The allegation that certain Defendants retained rebates despite contrary contract terms appeared for the first time in Relator's Amended Complaint. His initial Complaint alleges only that Sodexo and Aramark retained rebates per explicit contract terms and that Chartwells's contracts were silent on the subject of rebates. (Compl. ¶ 3.) Accordingly, the December 2005 audit may be considered by the Court as to this particular allegation. *See United States ex rel. Atkinson v. Pa. Shipbuilding Co.*, 255 F. Supp. 2d 351, 367 n.15 (2002) ("[T]he court must be concerned with whether the public disclosure of a given allegation predated the appearance of that allegation in [a relator's] complaint, *not* . . . whether the public disclosure antedated the inception of [the] action.").

as large FSMCs that typically contract with school districts. *GAO Report, School Lunch Program: Role and Impacts of Private Food Service Companies* 16. Relator himself acknowledges that Defendants are responsible for "45% or more of the FSMC-managed SFAs." (Compl. ¶ 18.) Accordingly, Defendants are not obscure companies engaged in minor level transactions, but are instead major players in the food service industry either already identified or easily identifiable as entities potentially involved in the publicly disclosed industry-wide scheme. Given the extent of the Government's investigation into FSMC rebate retention and the relative ease in identifying Defendants' involvement in the practice, Relator's identification of Defendants as perpetrators of the fraudulent behavior does not relieve his allegations from being based on public disclosures.

Although Relator's allegations of fraudulently-retained rebates have long been publicly exposed, Defendants have failed to identify any public disclosure of Relator's allegation that Defendants violated federal procurement regulations by failing to purchase food and related items in a manner that effectuates full and open competition. Sodexo points to a February 2002 audit and a July 2003 audit, which investigated cooperative buying groups (groups of SFAs joining together to acquire the purchasing power of a large organization) and concluded that they did not always comply with competitive bidding regulations. Southeast Region Audit, OIG, USDA, Report No. 27101-3-At, *Food and Nutrition Service*

National Lunch Program Procurement Process Southeast Region i (Feb. 2002); Great Plains Region Audit, OIG, USDA, Report No. 27010-10-KC, *Food and Nutrition Service National School Lunch Program Unified School District 248 Girard, Kansas* 2 (July 2003) [hereinafter "July 2003 Audit"]. Sodexo asserts that Relator's procurement-related allegations were disclosed because, "[w]hile the [July 2003 audit] addressed a situation involving a purchasing cooperative as opposed to a FSMC, the report specifically compared the cooperative to a FSMC." (Sodexo's Mem. at 18.)

Sodexo's argument fails. The July 2003 audit, which reported that the cooperative solicited bids directly from current suppliers instead of advertising for bids per relevant regulations, only referenced FSMCs in two sentences:

> We did not note any specific SA requirements that purchasing cooperatives had to follow similar to those agreements with food service management companies (FSMC). In contrast, the SA had specified that required provisions be included in contracts between SFA's and FSMC's. . . . We believe there needs to be a written agreement between SFA's and cooperatives covering all Federal and State requirements.

July 2003 Audit at 6. This notation illustrates that SFA's agreements with cooperatives, *unlike* those with FSMCs, lacked terms concerning federal regulations.

Clearly then, this audit cannot be extrapolated to cover Relator's allegations as to FSMCs.

Chartwells argues that Relator's procurement allegations have been disclosed because "[w]hile the OIG audit reports do not specifically discuss whether FSMCs submitted bids to local or national distributors, Relator's allegations are simply a sub-species of its allegation that Chartwells and other FSMCs were fleecing NSLP and SBP by retaining valuable discounts and rebates from national distributors." (Chartwells's Mem. at 15 n.11.) Relator's allegations as to procurement are distinct from his allegations regarding rebates – the two theories rely on different conduct and different regulations. Since none of the audits disclose that Defendants, by procuring goods from their national suppliers, were failing to abide by regulations requiring open and full competition, this allegation survives the FCA's jurisdictional bar.

Accordingly, this court has jurisdiction over those allegations pertaining to Defendants' failure to operate in compliance with federal procurement regulations, which were not publicly disclosed in an enumerated source.[5] However, whether jurisdiction

[5] In his memorandum of law in opposition to Defendants' motions to dismiss, Relator asserts another procurement related theory, despite having failed to plead it in his fifty-three page Amended Complaint. Quoting from FNS's December 2004 notice of proposed rulemaking, Relator asserts that Defendants caused SFAs to falsely certify compliance with procurement regulations by altering RFP terms to retain rebates, which compromises the procurement process. *See* 69 Fed. Reg. at 78342 ("[W]hen a

(Continued on following page)

exists over Relator's rebate-related claims, which were publicly disclosed by enumerated sources, depends on whether Relator qualifies as an original source of his allegations.

2. Relator is not an original source

When a relator's allegations are based upon publicly disclosed allegations or fraudulent transactions, his FCA claim is barred unless the relator qualifies as an original source. "'Original source' means an individual who has direct and independent knowledge of the information on which the allegations are based and has voluntarily provided the information to the Government before filing an action . . . which is based on the information." 31 U.S.C. § 3730(e)(4)(B); *Pranich*, 396 F.3d at 335. "Direct knowledge is knowledge obtained without any intervening agency, instrumentality or influence

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school food authority agrees to or allows a winning bidder to make changes to contract terms that are materially inconsistent with the underlying solicitation document, the [SFA] has subverted full and open competition by denying all bidders the opportunity to compete under the same terms and conditions."). The Court need not entertain this theory since it is not plead in Relator's Amended Complaint. However, the fact that the theory initially appears in Relator's opposition to Defendants' motions as a direct quote from the Federal Register illustrates that Relator plucked it directly from the public domain and is thus, barred by Section 3730(e)(4) from asserting it. *See Atkinson*, 473 F.3d at 522 ("[R]eliance solely on 'public disclosures' under § 3730(e)(4)(A) is *always* insufficient under § 3730(e)(4)(B) to confer original source status.").

immediate," while "[i]ndependent knowledge is knowledge that does not depend on public disclosures." *Atkinson*, 473 F.3d at 520 (internal quotations omitted). A relator he [sic] cannot establish that he is an original source solely by relying on "unsupported, conclusory allegation[s]." *Kennard*, 363 F.3d at 1044. In assessing Relator's original source status, the Court must examine the allegations contained in the Amended Complaint. *See Rockwell Int'l Corp. v. United States*, 549 U.S. 457, 473 (2007).

In *United States ex rel. Atkinson v. Pennsylvania Shipbuilding Co.*, 473 F.3d 506 (3d Cir. 2007), the Third Circuit addressed when a relator who relies on information that is public, but which is not publicized by an enumerated source, qualifies as an original source. Atkinson, the relator, alleged that Sun Ship and its successor Penn Ship conspired to and did defraud the United States Navy in connection with a contract to build oil tankers. The fact that Penn Ship failed to record the Navy's security interest in certain of Penn Ship's property had been publicly disclosed by virtue of the relator's FOIA request and a Department of Defense Office of the Inspector General Audit Report. At issue was whether Atkinson was an original source of this fact, which he learned from county records, a non-enumerated source.

The Third Circuit, relying on the Tenth Circuit's analysis in *Kennard v. Comstock Resources, Inc.*, 363 F.3d 1039, 1046 (10th Cir. 2004), explained that when a relator's knowledge of fraud is based on information that is public, but which was not disclosed by an

enumerated source, "courts should consider both 'the availability of the information and the amount of labor and deduction required to bring the claim.'" *Atkinson*, 473 F.3d at 522 (quoting *Kennard*, 363 F.3d at 1046). A relator who discovers fraudulent conduct from obscure records and whose considerable investigative efforts reveal a previously undisclosed fraud may qualify as an original source, whereas a relator who merely compiles public documents will be barred. This case-by-case approach is more likely to "fulfill the FCA's 'twin goals of rejecting suits which the government is capable or pursuing itself, while promoting those which the government is not equipped to bring on its own.'" *Id.* (quoting *Springfield Terminal*, 14 F.3d at 651). Although a non-insider relying on public documents can qualify as an original source, the Third Circuit cautioned that "courts must be mindful of suits based only on 'secondhand information, speculation, background information or collateral research. . . .'" *Id.* at 523 (quoting *United States ex rel. Hafter v. Spectrum Emergency Care, Inc.*, 190 F.3d 1156, 1162-63 (10th Cir. 1999)).

Applying these principles to Atkinson's case, the Third Circuit held that Atkinson did not qualify as an original source because anyone could have gone to the county recording office to see if defendants recorded their interest in accordance with the contract:

> [Relator's] research did not involve 'obscure' public records, nor were the public records only a small part of the information ultimately uncovered by his investigation.

> Indeed, it was *only* from review of information in the public domain that Atkinson learned of the failure to record . . . [T]he availability of the information was high and the amount of deduction was minimal. It takes little sophistication to conduct a survey of a filing; anyone interested in knowing whether Penn Ship recorded the instruments listed in the Trust Indenture could do so. Moreover, extrapolating from the absence of a recording to the fact that the instruments were not recorded does not require much interpretive rigor.

Atkinson, 473 F.3d at 524.

Relator's initial Complaint alleges that he questioned the value of lunches served in the public schools in his district, which led him to conduct "an in-depth study that caused him to conclude that his SFA was paying its FSMC, Sodexho, for food products and supplies, amounts that far exceeded Sodexho's net cost of procuring such goods, in violation of federal law." (Compl. ¶ 15.) From there, Relator allegedly initiated "a large scale investigation, wherein he interviewed approximately 50 individuals with first-hand knowledge of the [Complaint's] allegations" and "extensively analyzed financial reports and statements and reviewed dozens of FSMC contracts and hundreds of pages of other relevant material." (*Id.* ¶ 16.) The Amended Complaint provides no details of Relator's investigative efforts, but baldly asserts that his allegations are "not based upon any public disclosure" and that "Relator has direct and independent

knowledge of the information on which the allegations are based." (Am. Compl. ¶ 7.)

Accordingly, Relator claims that he is an original source of the allegations in his Amended Complaint because his knowledge of the "most critical elements" of his claims is "a result of an extensive, independent review of contracts, RFPs, invoices, Claims for Reimbursement, and discussions with school district personnel over the course of several years." (Relator's Opp'n at 23.) Assuming as the Court must, that Relator's knowledge of his allegations stems solely from public documents that do not constitute enumerated sources and interviews with (undisclosed) school district personnel, even though it is unlikely that he never came across OIG's audits in the course of his investigation, he proffers no details in support of his assertions. Indeed, the jurisdictional allegations in the Amended Complaint, the governing document in this case, are nothing but conclusory assertions that track the language of the FCA's jurisdictional bar. Although this alone would be fatal to Relator's claim, even taking Relator's self-described "extensive" investigation into account, he still does not qualify as an original source.

Relator relies heavily on *Kennard v. Comstock Resources, Inc.*, 363 F.3d 1039 (10th Cir. 2004), which the Third Circuit cited favorably in *Atkinson*. In that case, relators Kennard and Wright brought *a qui tam* action alleging that the defendant violated the FCA by underpaying an Indian Tribe on oil and gas leases regulated by the Secretary of the Interior. Wright

owned royalty interests in a tract of land near the Tribe's reservation and realized that his royalty payments drastically decreased after the defendant acquired a lease to that land. Wright informed Kennard of his realization and Kennard subsequently undertook an investigation. Based on a review of public records and using their oil and gas experience, the relators learned that the defendant was underpaying the Tribe and was aware of its underpayments. The relators had their attorneys draft a *qui tam* complaint and invited the Tribe to join in the action. However, the Tribe sued on its own behalf, thereby disclosing the relators' allegations in its complaint.

Despite this public disclosure, the Tenth Circuit held that jurisdiction existed over the relators' claims because the relators qualified as original sources. The court announced the principle that, where a relator relies on public information in support of his allegation, courts must assess the "degree and character" of the relator's reliance. *Id.* at 1045. The court concluded that the relators were original sources because they "did not merely label or translate an already publicly disclosed fraud," but instead, conducted their own investigation to discover a fraud of which the Government was unaware. *Id.* at 1046. The court emphasized that the Tribe's case would not have existed but for the relators' efforts. *Id.* at 1047 ("Through discovery and deduction, Relators ferreted out the alleged fraud in this case and must, therefore, qualify as an original source.").

This case is easily distinguishable from *Kennard*. In *Kennard*, the Government would have been wholly unaware of the defendant's fraudulent conduct absent the relators' efforts, whereas here the Government had already conducted several audits documenting FSMCs' retention of rebates and was planning regulatory action to address the problem. In *Kennard*, the relators analyzed obscure documents to discover a fraud, whereas Relator's investigation in this case consisted of compiling easily accessible public documents in order to support allegations of a fraud that had already been publicly disclosed. Furthermore, it takes little deduction to conclude that FSMCs are retaining rebates when their publicly available contracts *expressly provide* that they will, in fact, retain rebates. Although Relator also alleges that certain Defendants failed to pass through rebates when their contracts were silent on the issue or despite contrary contract terms, which is harder to establish, these allegations were also already publicly exposed. (*See* April 2002 audit at ii ("[T]he management companies amended, eliminated, or ignored terms included in the requests for proposal issued by the SFA's.").) Since this is a case that the Government was capable of pursuing on its own and which is based exclusively on Relator's review of public records and second hand information, both *Kennard* and *Atkinson* caution against jurisdiction. Accordingly, this Court lacks jurisdiction over Relator's rebate-related allegations because he is not an original source of those allegations.

B. Relator's Claims Fail Because He Cannot Establish a Regulatory Violation

Even if this Court possessed jurisdiction over Relator's rebate-related allegations, his claims fail, as do his procurement-related allegations. Relator alleges that Defendants caused false or fraudulent claims to be presented to the United States for payment, in violation of 31 U.S.C. § 3729(a)(1), and that Defendants caused a false record or statement to be made for purposes of securing payment from the United States government, in violation of 31 U.S.C. § 3729(a)(2). "To establish a *prima facie* case under 31 U.S.C. § 3729(a)(1) of the FCA, the relator must prove, '(1) the defendant presented or caused to be presented to an agent of the United States a claim for payment; (2) the claim was false or fraudulent; and (3) the defendant knew the claim was false or fraudulent.'" *United States ex rel. Schmidt v. Zimmer, Inc.*, 386 F.3d 235, 242 (3d Cir. 2004) (quoting *Hutchins v. Wilentz, Goldman & Spitzer*, 253 F.3d 176, 182 (3d Cir. 2001)). "In order to prove a claim under § 3729(a)(2), a plaintiff must also show that the defendant made or used (or caused someone else to make or use) a false record in order to cause the false claim to be actually paid or approved." *Id.* For liability to attach under either theory the claim must, in fact, be false.

Even if jurisdiction existed over Relator's rebate-related claims, dismissal would be warranted because he cannot establish that the claims submitted by SAs and SFAs were false or fraudulent. FNS explicitly

took the position that the federal cost principles in OMB Circular A-87 *did not apply* to cost-reimbursable contracts between FSMCs and SFAs. (*See* Nov. 26, 2002 Management Alert; Dec. 17, 2002 Rankin Memo; Jan. 15, 2003 Memo; May 20, 2003 Letter from Dir. of Child Nutrition Div.; July 9, 2004 Letter from Dir. of Child Nutrition Div.) FNS's position was that NSLP and SBP regulations did not require FSMCs to bill SFAs net of applicable rebates, discounts, or any other purchase incentives. Thus, irrespective of the plausibility of Relator's reading of the relevant regulations to require FSMCs to pass through rebates, Defendants cannot be liable because FNS, the federal agency administering the NSLP and SBP, took the position that those regulations did not apply to Defendants' contracts.[7] *See United States ex*

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[7] Relator may not bypass FNS's several memoranda disavowing OMB Circular A-87's applicability to FSMC's cost-reimbursable contracts by asserting that they are ambiguous and, thus, create a material issue of fact. (*See* Relator's Opp'n at 26-29.) All of the documents clearly establish that FNS's position, after discussing the issue with OMB, was that Circular A-87's requirements did not require FSMCs to pass through rebates to SFAs. No reasonable person could conclude otherwise. Moreover, even if FNS's directives were "ambiguous," Relator's rebate-related claims still fail because an ambiguous regulatory interpretation that reasonably could be read to authorize Defendants' conduct precludes a finding that Defendants knowingly submitted a false claim. *See United States ex rel. K & R Ltd. P'ship v. Mass. Housing Fin. Agency*, 530 F.3d 980 (D.C. Cir. 2008) (affirming summary judgment on relator's FCA claim where allegation of fraud depended on interpretation of ambiguous mortgage note and both parties' interpretations were plausible).

rel. Quinn v. Omnicare, Inc., 382 F.3d 432, 438 (3d Cir. 2004) (affirming summary judgment on claim that defendant violated the FCA by failing to adjust claims for Medicaid reimbursement because "if there is no requirement to adjust the claim, there is no liability for a failure to do so"); John T. Boese, *Civil False Claims and Qui Tam Actions* (3d ed. 2006) § 2.03[G][2] at 2-160 ("Before FCA liability may be imposed because of allegedly false certifications of compliance with an underlying statute, regulation, or contract, the plaintiff in an FCA case must prove that the alleged violation actually did occur.").

Although FNS did not proclaim OMB Circular A-87's inapplicability to cost-reimbursable contracts until late 2002, the Circular's application to SFA's contracts with FSMCs prior to that point was not as obvious as Relator asserts. On their face, the procurement regulations that incorporated OMB Circular A-87 did not apply to FSMCs. Prior to November 2007, regulations governing the NSLP stated that "*State Agencies* and *school food authorities* shall comply with the requirements of 7 CFR part 3016 or 7 CFR part 3019, as applicable, concerning the procurement of supplies, food, equipment and other services with Program funds."[8] 7 C.F.R. § 210.21

[8] The 2007 amendments to these regulations changed the language to incorporate OMB Circulars: "State agencies and school food authorities shall comply with the requirements of this part and 7 CFR Part 3016 or 7 CFR Part 3019, as applicable, which implement the applicable [OMB] Circulars, concerning the procurement of all goods and services with non-profit school

(Continued on following page)

(2007) (emphasis added); *see also id.* § 220.16 (same for SBP). Regulations at Part 3016 pertaining to financial administration dictate that grantees and subgrantees of federal funds may only pay allowable costs and incorporates OMB Circular A-87 for guidance regarding which costs are allowable. *Id.* § 3016.22. "Grantee" is defined as "the government to which a grant is awarded and which is accountable for the use of the funds provided" (here, the SAs) and "subgrantee" is defined as "the government or other legal entity to which a subgrant is awarded and which is accountable to the grantee for use of the funds provided" (here, the SFAs). 7 C.F.R. § 3016.3.

Since the regulations do not expressly apply to anyone other than SAs and SFAs, there is at least a reasonable basis for the position that the Circular's cost principles did not apply in cases of cost-reimbursable contracts with FSMCs. The reasonableness of this position is illustrated by FNS's change in position, and OMB and OIG's differing opinions. Indeed, if the regulations clearly prohibited FSMCs from retaining rebates in the first place, there would have been no need to amend them to prohibit SFAs from using nonprofit school food service account funds to reimburse FSMCs for claims in excess of the FSMCs' actual costs. *See* 7 C.F.R. § 210.21(f)(2). The lack of clarity regarding the proper interpretation of

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food service account funds." 72 Fed. Reg. at 61491 (codified at 7 C.F.R. § 210.21(a)); *see also id.* at 61494 (codified at 7 C.F.R. § 220.16(a)).

the regulations indicates that no basis exists for imposing FCA liability on Defendants, who merely adopted a reasonable interpretation of regulatory requirements which favored their interests.[9] *See United States v. Medica Rents Co., Ltd.*, Appeal Nos. 03-11297, 06-10393, 07-10414, 2008 WL 3876307, at *3 (5th Cir. 2008) (when authorities responsible for advising as to Medicare coding determinations created "substantial confusion" by giving defendant contradictory advice as to the proper medicare code for defendant's product, summary judgment was warranted on FCA claim); *United States ex rel. Lamers v. City of Green Bay*, 168 F.3d 1013, 1018 (7th Cir. 1999) ("[I]mprecise statements or differences in interpretation growing out of a disputed legal question are similarly not false under the FCA."); *cf. Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47, 127 S.Ct. 2201, 2216 n.20 (2007) (noting, in the context of the Fair Credit Reporting Act, that "[w]here . . . the statutory text and relevant court and agency guidance allow for more than one reasonable interpretation, it would defy history and current thinking to treat a defendant who merely adopts one such interpretation as a knowing or reckless violator").

Relator's allegations that Defendants' failure to procure goods in a manner consistent with federal

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[9] Moreover, it is unclear how Relator could prove any fraudulent misrepresentation by virtue of Defendants' retention of rebates in those instances when clear contract terms expressly permitted them to do so.

regulations caused local and state entities to file false certifications also fail. As noted above, these regulations apply solely to SAs and SFAs and not to FSMCs. The regulations at Part 3016 requiring "[a]ll procurement transaction [to] be conducted in a manner providing for full and open competition" apply only to "grantees" and "subgrantees" of federal funds-SAs and SFAs. 7 C.F.R. § 3016.36(c). The regulations pertaining to SFA's use of FSMCs clearly indicate that FSMCs were not required to procure food and other items in compliance with this, or other, procurement regulations at Part 3016. These regulations require "[a]ny *school food authority* that employs a food service management company in the operation of its nonprofit school food service" to "[a]dhere to the procurement standards specified in § 210.21 [which directs compliance with Part 3016] *when contracting with the food service management company.*" *Id.* § 210.16(a)(1) (emphasis added). This clarifies that procurement regulations apply to SFAs' contracting with FSMCs, not FSMCs' procurement of food or other goods on an SFA's behalf. Relator's argument that the regulations govern FSMCs' conduct, solely by virtue of their application to SAs and SFAs, lacks footing in the regulatory text, and, even if it were a plausible reading, is insufficient to establish a regulatory violation. *See Lamers*, 168 F.3d at1018. Accordingly, since FSMCs were not clearly required to abide by these regulations, Relator's allegations that

Defendants' violations thereof resulted in the filing of false claims fails.[10] *See Quinn*, 382 F.3d at 438.

IV. CONCLUSION

Relator's allegations that Defendants' retention of rebates caused SAs and SFAs to file false certifycations are barred by Section 3730(e)(4). Even if jurisdiction existed over these claims, they must be dismissed because Relator cannot establish that program regulations clearly mandated FSMCs to pass through rebates to SFAs. Likewise, Relator cannot establish that applicable regulations required FSMCs to procure goods in a manner promoting open competition, which is fatal to his FCA claim on that subject. Accordingly, Defendants' motions are granted.[11] An appropriate Order follows.

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[10] Because the Court finds that Relator's claims should be dismissed, either for lack of jurisdiction or failure to state a claim, it need not address Defendants' other arguments.

[11] The Court expresses its gratitude to the parties for their thorough briefing. These efforts and the many exhibits filed by the parties were helpful in resolving the issues raised by Defendants' motions. Because of this thorough briefing, the Court found it unnecessary to hold oral argument.

IN THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA

UNITED STATES,	:	
Plaintiff,	:	**CIVIL ACTION**
ROBERT PRITSKER,	:	
Relator,	:	
	:	
v.	:	
	:	
SODEXHO, INC., et al.,	:	**No. 03-6003**
Defendants.	:	

ORDER

AND NOW, this **6th** day of **March, 2009**, after consideration of Defendants' motions to dismiss, Plaintiff's opposition thereto and Defendants' replies thereon and for the foregoing reasons, it is hereby ordered that:

1. Defendants Sodexho, Inc.; Sodexho America, LLC; Sodexho Marriot Management, Inc.; and Sodexho Management Inc.'s Motion to Dismiss (Document No. 53) is **GRANTED**.

2. Defendants Aramark Corporation and Aramark Educational Services, Inc.'s Motion to Dismiss (Document No. 55) is **GRANTED**.

3. Defendant Compass Group USA, Inc.'s Motion to Dismiss (Document No. 57) is **GRANTED**.

4. The Clerk of Court is directed to close this case.

BY THE COURT:

/s/ Berle M. Schiller

Berle M. Schiller, J.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

09-1975

UNITED STATES OF AMERICA, ex rel.;
ROBERT PRITSKER

v.

SODEXHO, INC.; ARAMARK CORPORATION;
COMPASS GROUP USA, doing business as
Chartwells; SODEXHO AMERICA LLC; SODEXHO
MARRIOTT MANAGEMENT, INC.; SODEXHO
MANAGEMENT, INC; ARAMARK EDUCATIONAL
SERVICES, INC.

Robert Pritsker,

Appellant

SUR PETITION FOR REHEARING

Present: SCIRICA, *Chief Judge*, SLOVITER, McKEE, AMBRO, FUENTES, SMITH, FISHER, CHAGARES, and JORDAN, *Circuit Judges*, and STAPLETON, *Senior Circuit Judge**

The petition for rehearing filed by appellant in the above entitled case having been submitted to the judges who participated in the decision of this court

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* As to panel rehearing only.

and to all the other available circuit judges of the circuit in the regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court en banc, the petition for rehearing is denied.

By the Court,

MICHAEL A. CHAGARES
Circuit Judge

DATED: March 16, 2010
tmm/cc: Timothy Fazio, Esq.
John H. Williamson, Esq.
J. William BolandEsq.
Jeremy S. ByrumEsq.
Stephen A. CozenEsq.
Jennifer B. FureyEsq.
Martin F. Gaynor IIIEsq.
George M. Gowen IIIEsq.
William H. Jeffress Jr.Esq.
Jeffrey A. LamkenEsq.
Harry L. Manion IIIEsq.
Seth T. TaubeEsq.
Martin TotaroEsq.
Harvey WeissbardEsq.

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF PENNSYLVANIA

UNITED STATES OF AMERICA ex rel. PRITSKER,

Plaintiffs

– against –

SODEXHO, INC., ARAMARK CORPORATION and COMPASS GROUP USA, INC. (d/b/a CHARTWELLS)

Defendants.

Civil Action No. 03-6003

FALSE CLAIMS ACT COMPLAINT

JURY TRIAL DEMANDED

FILED UNDER SEAL

31 U. S.C. § 3730(b)(2)

(Oct. 30, 2003)

Plaintiff, the UNITED STATES OF AMERICA, *ex rel.* ROBERT PRITSKER ("Plaintiff" or "Relator"), as and for its Complaint against Defendants SODEXHO, INC., ARAMARK CORPORATION, and COMPASS GROUP USA, INC. (D/B/A CHARTWELLS) (collectively, "Defendants"), alleges as follows:

NATURE OF ACTION

1. Plaintiff brings this action to recover damages, treble damages, and civil penalties on behalf of the United States of America ("United States") under the False Claims Act, 31 U.S.C. §§ 3729-33. The damages arise from $530,000,000 of false claims and

statements made through school district grantees under the United States' National School Lunch Program ("NSLP") and from causing those grantees to present such false claims to the United States. Defendants, food service management companies ("FSMCs") made and/or caused to be made the false claims and statements, which continue to this day and originated when Defendants issued monthly invoices pursuant to which Defendants sought reimbursement for managing the food service of NSLP sponsoring school districts ("school food authorities" or "SFAs"). The false claims alleged here arose in the past ten years between 1993 and this present day in 2003 under cost reimbursable contracts between the SFAs and FSMCs, as a result of the FSMCs seeking reimbursement for costs they incurred in buying the food and supplies needed to feed the children attending the SFA schools. One such SFA is in the Eastern District of Pennsylvania.

2. Under the NSLP, 42 U.S.C. §§1753(b)(2), 1756, and 1759a payments are made by the United States Department of Agriculture ("USDA") to state agencies ("SAs") for every meal ("program meal") served in the SFAs that meets the nutritional requirements of the NSLP. The SAs distribute those USDA payments to the SFAs, based upon each SFA's monthly report of program meals served. The meal counts are maintained by Defendants, the food service managers, and submitted to the SFAs for signature and submission to the SA on a form prescribed by 7 CFR § 210.8, a section of the NSLP regulations

at 7 CFR § 210. The signatory on the form certifies that the claim is in accordance with the terms of the existing Agreement. According to 7 CFR §210.9, "[T]he Agreement shall contain a statement to the effect that the "School Food Authority and participating schools under its jurisdiction shall comply with all the provisions of 7 CFR parts 210 and 245.'" The Defendant FSMCs' form cost reimbursable contracts all have essentially the same provision regarding their compliance with the law concerned with the NSLP – they agree to comply with those same NSLP regulations set out in 7 CFR §§ 210, 245, *et seq.* 7 CFR§210.16 is entitled **Food service management companies**. Therein, the SFAs are regulated in terms of the contracts they may enter into with FSMCs. 7CFR§210.16(c) states, "Contracts. Contracts that permit all income and expenses to accrue to the food service management company and 'cost-plus-a-percentage-of-cost' . . . contracts are prohibited."

3. The FSMCs' claims for reimbursement are spelled out in their cost reimbursable contracts with the SFAs. The form cost reimbursable contracts of both Sodexho and Aramark, used with essentially every SFA they manage, called for those two FSMCs to retain all rebates, trade allowances, and discounts made available to them by national manufacturers, suppliers, and distributors, as a result of their volume purchases. (All three Defendants are multi-billion dollar companies making multi-billion dollar purchases annually under national buying contracts.) Chartwells' form cost reimbursable contract, essentially used

with every SFA it manages, is silent on the question of retention of national rebates.

4. The practice of rebates, discounts, allowances, etc. being returned to food industry large-volume buyers is a common one often referred to in the food industry as "Billbacks," as in the buyer billing back to the manufacturer, distributor, or supplier the amount of rebate commensurate with achieving a volume of purchases articulated in buying contracts entered into by companies such as Defendants.

5. Billbacks for purchases made by FSMCs on behalf of SFAs create a prohibited form of contract – the cost-plus-a-percentage-of-cost contract. Billbacks are markups worked backwards: were an FSMC with a cost of $8 to seek reimbursement of $10 for the same item from an SFA, that $2 markup defines the prohibited cost-plus-a-percentage-of-cost contract. An FSMC's paying a manufacturer $10, billing the SFA $10, only to billback the manufacturer for the $2 volume-purchaser rebate results in the exact same prohibited cost-plus-a-percentage-of-cost contract. The $2 is a percentage of cost in either case.

6. The prohibition against cost-plus-a-percentage-of-cost contracts in 7 CFR§210.16(c) demonstrates the NSLP regulations' consistency with 7CFR§3016 "Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments." 7CFR § 3016.22(b) states in part, " . . . For each kind of organization, there is a set of Federal principles for determining allowable costs. . . . For the

costs of a state, local, or Indian tribal government . . . " the regulation applies principles in OMB Circular A-87, which state at Attachment A § A(3) that the principles governing allowable costs in cost reimbursable contracts" will be applied by all Federal agencies in determining costs incurred by governmental units [or grantees] under Federal awards.

7. Under Circular A-87, "costs" must be "the net of all applicable credits," at Attachment A § C(1)(i), and meet "[m]arket prices for comparable goods or services," at Attachment A § C(2)(c). "Purchases should be charged at their actual prices after deducting all cash discounts, trade discounts, rebates, and allowances received," at Attachment B #29

8. 7CFR§210.16(c) also reflects consistency with the regulation in 7CFR§ 3016.36(4). 7CFR§3016.36(4) states, "Procurement. (4) The cost plus a percentage of cost . . . method(s) – of contracting shall not be used."

9. Relator estimates that, during the 1999-2000-school year, where cost reimbursable contracts were involved, Sodexho purchased $117 million of food and supplies on behalf of the SFAs it managed, Aramark $172 million, and Chartwells $90 million. (In 1999-2000 the Defendants did enter into approximately 110 fixed-price/fixed-price-per-meal-served contracts with SFAs, where their retention of Billbacks is entirely consistent with that NSLP permitted form of contract.) The Billbacks retained in the cost reimbursable contracts are estimated at 14% of such

purchases. The $53 million Billback result (14% x $379 million in total purchases) has been multiplied by ten years to equal the $530 million damage claim. While the Defendants' business with SFAs was growing steadily through the 1993 to September 1, 1999 period, using the 1999-2000 reference year retained Billback amount as an average retained Billback for all ten years is justified by the fact that the Defendants' SFA business has increased considerably since the reference year and that reference year represents a reasonable average of the ten years.

10. Payment by the USDA pursuant to the SFA claims for program meals served had the result of honoring the very form of SFA-FSMC contract the USDA regulations said it would not honor. The Defendants made it very clear in their contracts that they were aware of 7CFR§ 210, particularly as it relates to FSMCs in 7CFR§210.16, yet they knowingly, willingly, and intentionally became a party to such a prohibited contract for their sole benefit since they retained the Billbacks, and to the detriment of a USDA program established "to safeguard the health and well-being of the Nation's children and to encourage the domestic consumption of nutritious agricultural commodities and other food by assisting the States, through grants-in-aid [to] nonprofit school lunch programs." 7 CFR§ 210.1, *et seq.* and 42 U.S.C.§1751, *et seq.*

JURISDICTION AND VENUE

11. As required by 31 U.S.C. 3730(b)(2), the Plaintiff/Relator herein, has provided to the Attorney General of the United States and to the United States Attorney for the Eastern District of Pennsylvania a statement of material evidence and known information in support of this Complaint ("Disclosure Statement"). Relator's Disclosure Statement contains confidential information entitled to protection as privileged attorney-client communications and work product submitted to the Attorney General and United States Attorney.

12. This action arises under the False Claims Act, 31 U.S.C. §§ 3729 *et seq.* ("FCA" or "Act"). This Court has jurisdiction over this case pursuant to 31 U.S.C. §§ 3732(a) and 3730(b). This Court also has jurisdiction pursuant to 28 U.S.C. §§ 1331 and 1345, and has supplemental jurisdiction over any common law and equitable causes of action pursuant to 28 U.S.C. § 1367(a). Under the *qui tam* provisions of the Act, private persons such as the Relator may enforce the Act on behalf of the United States to recover amounts paid by the United States or a grantee thereof pursuant to a false or fraudulent claim or statement.

13. Venue is proper in this District pursuant to 28 U.S.C. § 1391(b) and (c), as at all times relevant hereto certain of the Defendants transacted business in this District.

THE PARTIES

Relator

14. Robert Pritsker ("Relator" or "Plaintiff"), age 62, is a non-practicing lawyer with an MBA. For many years, he was a well-established restaurateur in New York City, and continues to have a keen interest in the food service industry. Mr. Pritsker has expertise in all aspects of food management, including procurement, cost-of-goods, food preparation, costs-per-meal served, nutrition, etc.

15. Relator lives with his family in Weston, Connecticut. His 7-year old twin boys attend the local public elementary school. Because he began to question the value of lunches being served to students throughout his school district, Mr. Pritsker undertook an in-depth study that caused him to conclude that his SFA was paying its FSMC, Sodexho, for food products and supplies, amounts that far exceeded Sodexho's net cost of procuring such goods, in violation of federal law related to the NSLP.

16. What Plaintiff/Relator began to uncover as to the Weston School District, led him into a large-scale investigation, wherein he interviewed approximately 50 individuals with first-hand knowledge of the allegations made in the accompanying Disclosure Statement. He extensively analyzed financial reports and statements and reviewed dozens of FSMC contracts and hundreds of pages of other relevant materials.

Defendants

17. The Defendants are: Sodexho, Inc. ("Sodexho"), a wholly-owned subsidiary of Sodexho Alliance S.A., a French company, Aramark Corporation ("Aramark") and Compass Group USA, Inc., d/b/a Chartwells ("Chartwells").

18. Sodexho (headquartered in Gaithersburg, MD) and Aramark (headquartered in Philadelphia, PA) trade on the New York Stock Exchange; Chartwells is the "dba" for Compass Group USA, Inc., a division of Compass Group, a British company trading on the London Stock Exchange. The three Defendant FSMCs are believed to control 45% or more of the FSMC-managed SFAs.

NSLP CASH REIMBURSEMENTS TO SFAs

19. The Secretary of Agriculture allots NSLP funds to each state, taking into consideration states having lower than average income per capita. The NSLP employs income guidelines based upon poverty level and family size to determine the number of students eligible for free and reduced price lunches under NSLP. 42 U.S.C.§§ 1756, 1758(b), 7CFR§245 *et seq*. State agencies receiving such federal funds are required to make these funds available to reimburse or make advance payments to SFAs based upon their program meals served. 7 CFR §210.6, .7, .8. For the 2002-2003 school year, the Federal Government paid $0.20, $1.74 and $2.14/program meal served to students who, respectively, pay the full price charged

by the SFA, a reduced price of $0.40, or nothing. In the 1999-2000 reference-year, the NSLP cash grants to SFAs were $5.6 billion.

20. 1648 of the total 19,300 US school districts were managed by FSMCs in the 1999-2000-reference year. Defendants managed 746 SFAs of those 1648 or about 45% of FSMC-managed SFAs (false claims by the FSMCs managing the other 55% of SFAs may also exist) and, therefore, 3.8% of all US school districts' food service operations. The $53 million in Defendants' false claims in 1999-2000 represents 25% of the NSLP grant money of $213 million paid to the 3.8% of US school districts whose food service was managed by Defendants.

21. Federal regulations envision the type of investigative activity undertaken by Plaintiff/Relator: "School food authorities shall promote activities to involve . . . parents," including menu planning, nutrition practices and enhancement of the program. 7 CFR § 210.16(a)(8).

FACTS COMMON TO ALL COUNTS

22. The United States has sustained actual damages to the extent it, or its grantees, paid out federal funds received by Defendants that the US or its grantees would not have paid because of Billbacks received by Defendants.

23. The three Defendant FSMCs (and their predecessor companies for whose acts Defendants are

liable), knowingly and/or with reckless disregard for applicable federal law, made and/or caused to be made false claims equivalent to the amounts by which their reimbursement claims exceeded the net costs of FSMC purchases made on behalf of SFAs under cost reimbursable contracts.

24. The Defendants' false claims have occurred for a minimum of ten years.

25. The per year average over ten years of the aforesaid false claims by the three named Defendant FSMCs are being stated at $53 million per year, although an audit of the FSMCs' books is necessary to confirm this estimate.

26. Each Defendant made, on average, 1 monthly claim for reimbursement for 10 months of each school year per each SFA client. The three Defendants serviced an average of 750 SFAs for the 1993 to 2003 ten-year period. The incidence of false claims to which penalties may attach are therefore 75,000.

27. A 1986 amendment to 31 U.S.C.§ 3729 of the False Claims Act is directly applicable to the charges of this Complaint and provides in pertinent part:

> **(c) Claim defined.** For purposes of this section, claim includes any request or demand, whether under a contract or otherwise, for money or property which is made to a contractor, **grantee**, or other recipient if the United States Government provides any portion of the money or property which

> is requested or demanded, or if the Government will reimburse such contractor, grantee, or other recipient for any portion of the money or property which is requested or demanded. [emphasis added]

This statutory amendment enabled the United States to use the False Claims Act to reach fraud perpetrated on federal grantees, as recipients of federal funds.

28. In managing SFAs' food service, the Defendants have, as a matter of corporate policy, knowingly and/or recklessly disregarded the law and the clear legal boundaries that existed between practices where Billback retention might be appropriate and practices where Billback retention gives rise to false claims.

COUNT 1

(False Claims Act: Presentation of False Claims and/or causing the presentation of False Claims to be made)

29. Plaintiff/Relator re-alleges and incorporates the allegations of paragraphs 1 through 28 as though fully set forth herein.

30. Defendants knowingly made false representations and claims and/or caused the presentation of false claims to the United States in order to obtain reimbursement from the United States to which they otherwise would not have been entitled.

31. Defendants' course of conduct violated the False Claims Act, 31 U.S.C. §§ 3729 *et seq.* By reason of Defendants' actions, the United States suffered damages in an amount to be determined at trial, and is entitled to civil penalties of $5,000 to $11,000 for each violation and treble damages under the False Claims Act.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff/Relator respectfully requests this Court to enter judgment against Defendants, as follows:

(a) That the United States be awarded damages in the amount of civil penalties of $5,000 to $11,000 for each and every false claim that Defendants presented to the United States or its grantees and three times the total damages sustained by the United States because of the false claims and fraud alleged within this Complaint, as the False Claims Act, 31 U.S.C. §§ 3729 *et seq.* provides;

(b) That pre- and post-judgment interest be awarded, along with reasonable attorneys' fees, costs and expenses which Plaintiff/Relator necessarily incurred in bringing and prosecuting this case;

(c) That the Court grant permanent injunctive relief to prevent any recurrence of the violation of the False Claims Act for

which redress is sought in this Complaint;

(d) That Relator be awarded the maximum amount allowed to him pursuant to the False Claims Act; and

(e) That this Court award such other and further relief as it deems proper.

DEMAND FOR JURY TRIAL

Plaintiff/Relator demands a trial by jury as to all issues triable by a jury.

Dated: October 24, 2003

Respectfully submitted,

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/s/ Robert Pritsker, Pro Se
Robert Pritsker, Pro Se

FILED OCT 30 2003

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT
OF PENNSYLVANIA

UNITED STATES OF AMERICA, Plaintiff, ROBERT PRITSKER, RELATOR and PLAINTIFF, vs. SODEXHO, INC., SODEXHO AMERICA, LLC, SODEXHO MARRIOTT MANAGEMENT, INC., SODEXHO MANAGEMENT, INC., ARAMARK CORPORATION, ARAMARK EDUCATIONAL SERVICES, INC., and COMPASS GROUP USA, INC. (d/b/a CHARTWELLS), DEFENDANTS.	**FILED UNDER SEAL** **Civil Action No. 03-600360003** **FALSE CLAIMS ACT COMPLAINT 31 U.S.C. § 3729, *et seq.*** **JURY TRIAL DEMANDED** **(Filed Aug. 1, 2007)**

FIRST AMENDED COMPLAINT

Relator ROBERT PRITSKER ("Relator"), on behalf of himself and the United States, brings this civil action under the False Claims Act, 31 U.S.C. § 3729, *et seq.* for damages, penalties, and such other relief as the Court may order against Defendants

SODEXHO, INC., SODEXHO AMERICA, LLC, SODEXHO MARRIOTT MANAGEMENT, INC., SODEXHO MANAGEMENT, INC., ARAMARK CORPORATION, ARAMARK EDUCATIONAL SERVICES, INC., and COMPASS GROUP USA, INC. (D/B/A CHARTWELLS) (collectively, "Defendants"), and alleges upon information and belief as follows:

NATURE OF ACTION

1. This action seeks tens of millions of dollars in damages to the Federally-funded National Student Lunch Program ("NSLP") and School Breakfast Program ("SBP") by Defendants as a result of false and fraudulent claims submitted to the United States for payment in violation of the False Claims Act (the "FCA" or the "Act"), 31 U.S.C. § 3729 *et seq.* Defendants are Food Service Management Companies ("FSMCs") that manage and operate food services for hundreds of school food authorities ("SFAs") nationwide participating in the NSLP and SBP entitlement grant programs.

2. The NSLP and SBP are multi-billion dollar Federally-funded entitlement grant programs that provide assistance to States in the form of cash and commodities donated by the United States Department of Agriculture ("USDA") to benefit non-profit food services in K-12 schools. As set forth more fully herein, for more than a decade, Defendants have siphoned off millions of dollars in surreptitious profits to the detriment of the Federal NSLP and SBP

programs and taxpayers (i) by failing to credit SFAs, with whom Defendants have entered into cost-reimbursable contracts, with rebates, discounts and allowances Defendants received from food manufacturers and national distributors; and (ii) caused additional damaged [sic] to those Federally-funded programs by funneling their purchases of food and supplies through national distributors that enabled the Defendants to enjoy such rebates rather than seeking competitive prices from local distributors who offered lower prices on like goods purchased by Defendants acting on behalf of the SFAs but did not offer Defendants the opportunity to enjoy any of those rebates.

3. As a result of this scheme, Defendants have caused SFAs and state agencies (SAs) that obtain NSLP and SBP entitlement grant money for qualified meals served by SFAs to make false certifications of compliance with regulations applicable to the NSLP and SBP that prohibit grantees (i) from incurring costs that are not net of all available rebates, discounts, and allowances, and (ii) from conducting procurement transactions in a manner that does not provide full and open competition.

4. In this suit, Relator, on behalf of himself and the United States, seeks all the remedies available under the FCA, 31 U.S.C. § 3729, *et seq*. These include civil penalties of up to $11,000 and a minimum of $5,000 per false claim against each Defendant and three times the amount of damages that the United States has sustained because of these

false claims, as well as reasonable attorneys' fees and costs associated with prosecuting this action.

JURISDICTION AND VENUE

5. This Court has jurisdiction over this ease [sic] pursuant to 31 U.S.C. §§ 3732(a) and 3730(b)(1), and 28 U.S.C. §§ 1331 and 1345.

6. Venue is proper in this District pursuant to 28 U.S.C. § 1391(b) and (c) and 31 U.S.C. § 3732(a), which provides that any action brought under 31 U.S.C. § 3730 may be brought in any judicial district in which the defendant, or in the case of multiple defendants, any one defendant can be found, resides, transacts business, or in which any act proscribed by 31 U.S.C. § 3729 occurred.

7. This action is not based upon any public disclosure of information within the meaning of 31 U.S.C. § 3730(e)(4)(A). To the extent any of these allegations may have been publicly disclosed within the meaning of 31 U.S.C. § 3730(c)(4)(A) [sic], Relator has direct and independent knowledge of the information on which the allegations are based within the meaning of 31 U.S.C. § 3730(e)(4)(B) and voluntarily provided the information to the Government before this action was filed.

8. As required by 31 U.S.C. § 3730(b)(2), the Relator provided to the United States Attorney General and to the United States Attorney for the Eastern District of Pennsylvania a Statement of

Disclosure containing material evidence and known information in support of this Complaint.

PARTIES

9. Relator Robert Pritsker is a resident of the State of Connecticut, and is an individual over the age of twenty-one (21). Mr. Pritsker resides in Weston, Connecticut and his children attend school in the Weston School District. Defendant Sodexho, Inc. ("Sodexho") was the FSMC for the Weston School District from at least 1998 until 2004.

10. Defendant Sodexho is an FSMC that has entered into cost reimbursable food service management contracts with SFAs throughout the country participating in the NSLP and SBP entitlement grant programs. Defendant Sodexho is headquartered in Gaithersburg, Maryland, and is a wholly-owned subsidiary of Sodexho Alliance, SA, a leading global provider of food and facilities management headquartered in Paris, France. Sodexho is a leading foodservice operator in North America serving corporations, health care, long term care and retirement centers, schools, college campuses, and the government. For its fiscal year ended August 31, 2006, Sodexho, Inc. had revenues of approximately $6.7 billion. As alleged herein, in violation of 31 U.S.C. § 3729, *et seq.*, Defendant Sodexho, doing business through its subsidiaries Sodexho America, LLC, Sodexho Marriott Management, Inc. and Sodexho Management Inc., also headquartered in

Gaithersburg, Maryland, (i) knowingly caused false claims to be presented for payment or approval to the United States under the NSLP and SBP entitlement grant programs, and (ii) knowingly caused to be made or used a false record or statement to get a false or fraudulent claim paid or approved by the Government.

11. Defendant Aramark Corporation ("Aramark") is a Delaware corporation headquartered in Philadelphia, Pennsylvania, within this district. Defendant Aramark is an FSMC that has entered into cost reimbursable food service management contracts with SFAs throughout the country participating in the NSLP and SBP entitlement grant programs. Aramark is one of the largest food, hospitality and facilities management companies in the United States. For its fiscal year ended September 29, 2006, Aramark reported sales in excess of $11 billion and net income of more than $260 million. On January 26, 2007, Defendant Aramark announced the completion of a merger in which Aramark was acquired by an investor group led by Joseph Neubauer, Aramark's chairman and chief executive officer, and investment funds managed by GS Capital Partners, CCMP Capital Advisors and J.P. Morgan Partners, Thomas H. Lee Partners and Warburg Pincus LLC. As alleged herein, in violation of 31 U.S.C. § 3729, *et seq.*, Defendant Aramark, doing business through its subsidiary Aramark Educational Services, Inc. also headquartered in Delaware, (i) knowingly caused false

claims to be presented for payment or approval to the United States under the NSLP and SBP entitlement grant programs, and (ii) knowingly caused to be made or used a false record or statement to get a false or fraudulent claim paid or approved by the Government.

12. Defendant Compass Group USA, Inc., d/b/a Chartwells ("Chartwells"), is a division of Compass Group, a British company trading on the London Stock Exchange. Chartwells, which is headquartered in Charlotte, North Carolina, provides managed foodservices to corporate clients, educational and healthcare facilities and entertainment venues. Defendant Chartwells is an FSMC that has entered into cost reimbursable food service management contracts with SFAs throughout the country participating in the NSLP and SBP entitlement grant programs. For its fiscal year ended September 30, 2006, Chartwells had revenues of approximately $8.58 billion. As alleged herein, in violation of 31 U.S.C. § 3729, *et seq.*, Defendant Chartwells (i) knowingly caused false claims to be presented for payment or approval to the United States under the NSLP and SBP entitlement grant programs, and (ii) knowingly caused to be made or used a false record or statement to get a false or fraudulent claim paid or approved by the Government.

13. Defendants Sodexho, Inc., Sodexho America, LLC, Sodexho Marriott Management, Inc., Sodexho Management, Inc., Aramark Corporation, Aramark Educational Services, Inc., and Compass Group USA,

Inc. (d/b/a Chartwells) are referred to collectively as "Defendants." Defendants managed food service operations for more than 700 SFAs during the 1999-2000 school year. By the 2005-2006 school year, this number had more than doubled.

SUBSTANTIVE ALLEGATIONS

I. THE NSLP, THE SBP AND APPLICABLE FEDERAL REGULATIONS

14. On June 4, 1946, Congress passed the National School Lunch Act, 42 U.S.C. § 1751, which authorized and established the NSLP. The National Student Lunch Act states in pertinent part that:

> It is declared to be the policy of Congress, as a measure of national security, to safeguard the health and well-being of the Nation's children and to encourage the domestic consumption of nutritious agricultural commodities and other food, by assisting the States, through grants-in-aid and other means, in providing an adequate supply of foods and other facilities for the establishment, maintenance, operation, and expansion of nonprofit school lunch programs.

Id. at 42 U.S.C. §1751.

15. On October 11, 1966, Congress established a pilot project to assist schools serving breakfast to nutritionally needy children. On October 7, 1975, Congress made the project final and passed the

School Breakfast Program, 42 U.S.C. § 1773, which authorized and established the SBP.

16. The NSLP and SBP provide Federal assistance in cash and commodities donated by the United States Department of Agriculture ("USDA") to the States in order to benefit K-12 schools' non-profit food services. For the 2004-2005 school year, the USDA's Food and Nutrition Service ("FNS"), which administers the NSLP and SBP, disbursed approximately $10 billion in connection with these programs.

17. NSLP and SBP entitlement grant money is paid to grantee state agencies (SAs), usually state education agencies, which are responsible for administering the NSLP and SBP statewide and for distributing NSLP and SBP entitlement grant money to SFA sub-grantees based on Claims for Reimbursement prepared by SFAs (or by an FSMC on an SFA's behalf) indicating the number of program meals served. The FNS enters into written agreements with SAs pursuant to which the SAs agree to comply with the NSLP, the SBP and applicable program regulations found at 7 C.F.R. §§ 210, 220, 3015 and 3016. Form FNS-74 – Federal State Agreement Child Nutrition and Food Distribution Programs Food and Nutrition Service U.S. Department of Agriculture states in pertinent part:

> 9. What are the requirements for FNS?
>
> Subject to available appropriations, FNS will provide funds and commodities to the State Agency for the programs covered by this

agreement . . . . FNS will provide the funds and commodities in accordance with program statutes, program regulations, and FNS instructions, policy memoranda, guidance, and other written directives interpreting the program statutes and program regulations, and the other statutes and regulations cited in this agreement.

10. What are the requirements for the State agency?

Program Statutes, Program Regulations, Instructions, Policy Memoranda, and Guidance

The State agency will comply with the program statutes and program regulations applicable to the programs covered by this agreement. The State agency also will comply with any FNS instructions, policy memoranda, guidance, and other written directives interpreting the program statutes and program regulations applicable to those programs.

Departmental Regulations on Grants and Cooperative Agreements

The State Agency will comply with the following USDA Regulations:

7 CFR Part 3015, Uniform Federal Assistance Regulations

7 CFR Part 3016, Uniform Administrative Requirements for Grants and Cooperative Agreements . . . .

18. Each SFA participating in the NSLP and SBP must enter into a written agreement ("Agreement") with the relevant SA containing the same representations set forth in the FNS-SA Agreement. 7 C.F.R. §§ 210.9(b), 220.7. Pursuant to Federal regulations [7 C.F.R. §§ 210.7(a), 220.10], reimbursement payments under the NSLP and SBP may be made only to SFAs operating under a written Agreement with a SA. Federal regulations permit SFAs to contract with FSMCs to manage nonprofit school foodservice operations in K-12 schools. 7 C.F.R. §§ 210.16, 220.7(d).

19. Pursuant to Federal regulations [7 C.F.R. §§ 210.5(a), 220.16(a)], recipients of federal NSLP and SBP entitlement grant money (*i.e.*, SAs and SFAs) must comply with 7 C.F.R. § 3016 (and prior to July 1, 2001, 7 C.F.R. § 3015), which restricts the use of Federal entitlement grant money. Specifically, "[g]rant funds may be used only for: (1) The allowable costs of the grantees [or] subgrantees . . . ; and (2) Reasonable fees or profit to cost-type contractors but not any fee or profit (or other increment above allowable costs) to the grantee or subgrantee." 7 C.F.R. § 3016.22(a). Because Federal NSLP and SBP entitlement grant funds are delivered to and administered through SAs, 7 C.F.R. § 3016.22(b) directs that the allowable cost provisions of OMB Circular A-87 ("A-87") apply. OMB A-87 states in relevant part:

> Materials and supplies costs:
>
> a. Costs incurred for materials, supplies and fabricated parts necessary to carry out a Federal award are allowable.
>
> b. ***Purchased materials and supplies shall be charged at their actual prices, net of applicable credits.*** Withdrawals from general stores or stockrooms should be charged at cost under any recognized method of pricing inventory withdrawals, consistently applied. Incoming transportation charges are a proper part of materials and supplies costs.

Id. at OMB Circular A-87 (May 10, 2004), Attachment B at ¶ 26. The Circular defines "applicable credits" as:

> [R]eceipts or reductions of expenditure-type transactions that offset or reduce expense items allocable to Federal awards as direct or indirect costs. Examples of such transactions are: purchase discounts, rebates or allowances, recoveries or indemnities on losses, insurance refunds or rebates, and adjustments of overpayments or erroneous charges.

20. Further, 7 C.F.R. § 3016.36(c) provides that "[a]ll procurement transactions will be conducted in a manner providing full and open competition." "[S]ituations considered to be restrictive of competition include, [among other things,] . . . (iii) Noncompetitive pricing practices between firms or between affiliated companies, . . . [and] (vii) . . .

arbitrary action in the procurement process." Pursuant to 7 C.F.R 3016(d)(1)-(3), methods of procurement to be followed are limited to (i) procurement by small purchase procedures (to be used with respect to purchases costing less than $100,000) after obtaining price or rate quotes from an adequate number of qualified sources; (ii) procurement by sealed bid; and (iii) procurement by competitive proposals. Procurement by noncompetitive proposals (*i.e.*, through solicitation of a proposal from only one source) may be used only when the award of a contract is infeasible under small purchase procedures, sealed bids or competitive proposals and one of the following applies: (A) The item is available only from a single source: (B) The public exigency or emergency for the requirement will not permit a delay resulting from competitive solicitation; (C) The awarding agency authorizes noncompetitive proposals; or (D) After solicitation of a number of sources, competition is determined inadequate." 7 C.F.R. § 3016(d)(4)(i).

21. Federal regulations [7 C.F.R. § 210.16(a)(1)] mandate that any SFA that employs an FSMC with respect to its food service operations must "[a]dhere to the procurement standards specified in 7 C.F.R. § 210.21," which requires SAs and SFAs to comply with the requirements of 7 C.F.R. § 3016 "concerning the procurement of supplies, food, equipment and other services with [NSLP and SBP] funds." *See also* 7 C.F.R. §220.13(i).

22. Pursuant to Federal regulations, in order to receive Federal reimbursement dollars from the grantee SAs, "each school food authority shall submit to the State agency, a monthly Claim for Reimbursement, as described in paragraph (c) of this section." 7 C.F.R. § 210.8(b); *see also* 7 C.F.R. § 220.11(a). "The Claim for Reimbursement shall include data in sufficient detail to justify the reimbursement claimed and to enable the State agency to provide the Report of School Program Operations required under § 210.5(d) of this part." 7 C.F.R. §§ 210.8(c), 220.11(b). Schools that participate in both the NSLP and the SBP may submit one claim for reimbursement to cover both programs. 7 C.F.R. § 220.11(c). Claims for Reimbursement "shall be signed by the school food authority official." 7 C.F.R. § 210.8(c). The signatory on the form certifies that the claim is in accordance with applicable regulations or the terms of the existing Agreement between the SFA and SA, which mandate compliance with, *inter alia*, 7 C.F.R. §§ 210, 220, 3015, and 3016. Prior to 2001, SFAs filed hard copies of their Claims for Reimbursement. Since then, however, Claims for Reimbursement are filed online and a box containing the certification must be checked in order for the claim to be submitted.

23. SAs file monthly and annual reports (on form FNS-10) and total the Claims for Reimbursement received from SFAs in their respective States in support of their requests for NSLP and SBP entitlement grant money. 7 C.F.R. §§ 210.5(d),

220.13(b)(1). In addition, SAs file quarterly reports on Form SF-269 certifying "that all outlays and unliquidated obligations are for the purposes set forth in the award documents." 7 C.F.R. §§ 210.19, 220.13(b)(2). Federal entitlement grant money received by SFAs must be deposited into the nonprofit school foodservice account. SFAs, in turn, use these funds to pay cost reimbursement plus management fee invoices received from Defendants.

24. Federal regulations [7 C.F.R. § 210.16(c)] also prohibit "cost-plus-a-percentage-of-cost" contracts.

II. DEFENDANTS KNOWINGLY CAUSED FALSE CLAIMS TO BE MADE IN VIOLATION OF THE FCA

A. Defendants' Retention of Rebates

25. During the relevant period, Defendants contracted with hundreds of SFAs nationwide to manage foodservice operations on a cost-reimbursable contract basis. Pursuant to these cost-reimbursable contracts, Defendants billed SFAs for the costs incurred by Defendants in managing and operating foodservices for the SFAs including (i) costs of food, beverages and supplies purchased by Defendants on behalf of the SFAs; (ii) salaries and wages of Defendants' employees involved in operating the foodservice; and (iii) other costs incurred by Defendants that were necessary to discharge their obligations under the contracts. In addition, these cost-reimbursable contracts allowed Defendants to

charge specified "management" and "administration" fees usually expressed as pennies per meal. These amounts were paid to Defendants by the SFAs using NSLP and SBP entitlement grant money that SFAs and SAs obtained by certifying compliance with applicable NSLP and SBP regulations and Federal regulations set forth above. Defendants' evidenced their awareness of the regulations governing the SAs and SFAs in their contracts, which contained provisions stating that Defendants would fully comply with all applicable laws, rules and regulations including those enumerated above governing payments to grantees and sub grantees pursuant to the NSLP and SBP.

26. In fact, although Federal regulations required SFAs' purchases to be net of all rebates, discounts and allowances and Requests for Proposal ("RFPs") issued by SFAs and received and reviewed by Defendants made this clear, Defendants later excluded this language from their contracts and instead inserted provisions permitting Defendants to retain rebates, discounts and allowances received from national distributors and food manufacturers. Alternatively, although certain of Defendants' contracts stated that rebates would be passed through to the SFAs as required by the NSLP, the SBP and applicable Federal regulations or were silent as to this specific issue, in fact, Defendants retained these rebates.

27. As large volume buyers in the food industry, Defendants obtained significant rebates, discounts

and allowances from national food manufacturers and distributors which reduced the cost to Defendants of the goods they purchased on behalf of SFAs. These rebates came in two forms: (i) a "rigged" spread negotiated between Defendants and food manufacturers that resulted in a higher "into distribution price" for the food being purchased for SFAs contracting with Defendants, which was then "billed back" to the manufacturers by Defendants and returned by the manufacturers to Defendants in the form of a rebate; and (ii) a rebate off the distributors' mark-up of the "into distribution price" offered by national distributors such as Sysco for such things as drop size, prompt payment, Web-based ordering and buying goods branded with the distributors' name. While these "rebates" resulted in substantial profits for Defendants, they significantly and artificially increased the cost of food and supplies purchased for the SFAs, which was paid with Federal NSLP and SBP entitlement grant funds. Prices paid by SFAs with NSLP and SBP funds were further increased by the mark-up of the higher "into distribution price" by the national distributors with whom Defendants contracted.

28. The rebates retained by Defendants and Defendants' purchases of food and supplies on behalf of SFAs through national distributors substantially increased Defendants' remuneration under their contracts with SFAs far beyond the management and administrative fees of pennies per meal stated in the contracts.

29. In addition, Defendants' rebate retention scheme effectively transformed Defendants' cost-reimbursable contracts into prohibited "cost-plus-a-percentage-of-cost" contracts. Were an FSMC with a net cost of $8 to seek reimbursement of $10 for the same item from an SFA, that $2 markup defines the prohibited cost-plus-a-percentage-of-cost contract. An FSMC's paying a distributor $10, billing the SFA $10, only to billback the manufacturer for the $2 rebate results in the exact same prohibited cost-plus-a-percentage-of-cost contract. The $2 is a percentage of the net cost of $8.

30. In view of the foregoing, the certifications of compliance with NSLP and SBP rules and applicable Federal regulations by SAs and SFAs in order to access NSLP and SBP entitlement grant funds, which were a condition of participation and payment in the programs, were false.

1. SODEXHO

31. Hundreds of cost-reimbursable contracts between Sodexho and SFAs during the relevant period expressly provided that Sodexho would retain rebates, discounts and allowances from food manufacturers and national distributors in whole or in part. For example, many of Sodexho's contracts with SFAs including, but not limited to, those set forth below, contained substantially identical provisions with respect to rebates, discounts and allowances stating: "Operating expenses shall be the net of any

rebates obtained from local vendors, suppliers, or distributors for goods procured solely for Client's account. ***Prompt payment discounts and any other rebates or allowances obtained from vendors, suppliers, or distributors including those obtained through regional or national purchasing arrangements, will be retained by [Sodexho]. In any event, however, the invoiced amounts of such goods shall be competitive, on an aggregate basis, with prices at which such goods and services can be purchased in the geographic area of the Food Service operations, whether those goods are distributed through an unaffiliated distributor.***"

32. Sodexho contracts containing language substantially similar to the foregoing include, but are not limited to:

(a) Management Agreement dated August 1, 2001, between Sodexho America, LLC and the Orange County Public School District in Orange, Virginia. This contract was later extended through June 2005 by an amendment dated August 18, 2004, between the Orange County Public School District and Sodexho Management, Inc.

(b) Management Agreement effective July 1, 2005, between Sodexho Marriott Management, Inc. and the Rutland, Vermont Public Schools. This contract was later amended by an addendum dated August 18, 2005, between Rutland Vermont Public

Schools and Sodexho Management, Inc, which contains the foregoing language.

(c) Management Agreement dated May 2, 2001, between Sodexho America, LLC and the Edina Independent School District #273 in the city of Edina, Minnesota. This contract was later extended through June 2003 by agreement effective July 1, 2002, between Sodexho America, LLC and Edina Independent School District #273.

(d) Management Agreement effective July 1, 2000, between Sodexho America, LLC and the Faribault Independent School District # 656 for the city of Faribault, Minnesota. This contract was later extended through June 2005 by agreement dated April 14, 2004, between Sodexho America, LLC and Faribault Independent School District # 656.

33. Sodexho knew, or recklessly disregarded, that its retention of rebates, discounts and allowances caused false claims to be submitted to the United States. The cost-reimbursable contracts in question were awarded to Sodexho based upon its responses to Requests for Proposal ("RFPs") issued by SFAs, which made clear that SFAs were to receive all rebates and discounts, and mandated FSMC proposal and contract compliance with all applicable NSLP and SBP rules and Federal regulations. For example:

(a) The Orange County Public Schools RFP, for Orange, Virginia issued June 25, 2001, provided that: (i) "The FSMC shall conduct all food service program operations in accordance with 7 CFR Parts

210, 215, 220, 245, 250." [Standard Terms and Conditions, Article I.D]; (ii) "The FSMC shall comply with the rules and regulations of the VA DOE and the USDA, and any additions or amendments thereto, including but not limited to 7 CFR Parts 210, 215, 220, 245, and 250 and Title 7 CFR Part 225 (SFSP), if applicable. . . ." [Standard Terms and Conditions, Article I.M]; and (iii) "OCPS shall receive any and all discounts or rebates for purchases made on their behalf." [Standard Terms and Conditions, Article XII.B];

(b) The Rutland Public School District of Rutland, Vermont, published an RFP in the Spring of 2005, which provided: (i) "The FSMC shall comply with the rules and regulations of the Commissioner of Education, State of Vermont, and the United States Department of Agriculture and any conditions or amendments thereto." [Section II, Scope and Purpose, 2(F)]; (ii) "The FSMC shall purchase all food and non-food commodities at the lowest price possible, consistent with maintaining quality standards." [Section II, Specifications, 12(A)]; and (iii) "Any proposals submitted shall be in accordance with the laws of the State of Vermont, regulations and standards of the Vermont Department of Education, and shall conform to the standards of the United States Department of Agriculture." [Section II, Specifications, 22];

(c) The Edina School District #273 for the city of Edina, Minnesota issued an RFP in the spring of 2001 for the 2001-2002 school year which provided:

(i) "The Contractor shall purchase all food and supply items required by the food service program except to the extent those items are available through the USDA Commodity Program. Such purchases shall comply with all applicable regulations of the USDA and the DESE and shall include the use of competitive bidding, when applicable." [General Information, Article V, ¶T];

(d) The Faribault Independent School District #656 for the city of Faribault, Minnesota issued an RFP in the spring of 2000 for the 2000-2001 school year which provided: (i) "The Operator shall comply with all laws and regulations applicable to its food services operations hereunder." (RFP at 8); and (ii) "For the purpose of this Agreement, the Actual Food Service Operating cost shall consist of the following: (1) The actual cost of all food, beverages and supplies purchased by the Operator for food services operation on the premises, excluding donated commodities, but including processed commodity charges, applicable taxes and delivery charges, less all applicable discounts and rebates." (RFP at 10).

34. Upon information and belief, Sodexho invoiced SFAs for costs consistent with the terms of the aforementioned cost reimbursement contracts and other cost-reimbursable contracts without crediting the SFAs for the rebates, discounts and allowances it had obtained from food manufacturers and national distributors (no such rebates were reflected on Sodexho's invoices to SFAs). Upon information and belief, Sodexho invoices paid by SFAs with NSLP and

SBP entitlement grant funds that reflected costs that were not net of rebates, discounts and allowances as required by applicable NSLP and SBP rules and Federal regulations include, but are not limited to, the following:

(a) Orange County, Virginia School District:

i. Sodexho Invoice # 1000082817 dated October 9, 2004, in the amount of $84,865.17 paid by check # 0059343.

ii. Sodexho Invoice # 1000082691 dated November 6, 2004, in the amount of $82, 295.11 paid by check # 0059343.

(b) Rutland, Vermont City Public Schools:

i. Sodexho Invoice # 1000131197 dated October 11, 2005, in the amount of $159,525.28 paid by check # 83665.

(c) Edina, Minnesota School District #273:

i. Sodexho Invoice # 283925 dated October 15, 2001, in the amount of $244,505.18 paid by check # 223255.

ii. Sodexho Invoice # 285774 dated November 12, 2001, in the amount of $254,115.87 paid by check # 223982.

(d) Faribault, Minnesota School District:

i. Sodexho Invoice # 1000087115 dated December 4, 2004, in the amount of $26,763.81 paid by check # 54610.

ii. Sodexho Invoice # 326824 dated November 30, 2004, in the amount of $60,973.00 paid by check # 54283.

iii. Sodexho Invoice # 326823 dated November 12, 2004, and Invoice # 1000084881 dated November 8, 2004, in the amounts of $73,868.00 and $46,470.00, respectively, paid by check # 54000 in the amount of $120,338.00.

iv. Sodexho Invoice # 326822 dated November 3, 2004, in the amount of $77,519.00 paid by check # 53751.

v. Sodexho Invoice # 326821 dated October 15, 2004, in the amount of $67,765.00 paid by check # 53271.

35. By invoicing SFAs and receiving payment from NSLP and SBP entitlement grant funds for costs that were not net of rebates, discounts, and allowances received from food manufacturers and national distributors, Sodexho caused false certifications of compliance with applicable NSLP and SBP rules and Federal regulations and the Agreements between SFAs and SAs that were presented to the United States in connection with accessing NSLP and SBP entitlement grant funds. Upon information and belief, SFAs contracting with Sodexho including, but not limited to, those set forth above, obtained NSLP and

SBP entitlement grant funds by filing Claims for Reimbursement falsely certifying compliance with applicable NSLP and SBP program regulations and Federal regulations and the terms of the Agreements when, in fact, the costs Sodexho was charging the SFAs were neither net of rebates (and thus were effectively equivalent to the prohibited cost-plus-a-percentage-of-cost contract) nor, as set forth more fully below, procured in a manner providing full and open competition as required. Claims for Reimbursement including such false certifications caused by Sodexho include, but are not limited to, the following:

(a) Orange County School District for Orange, Virginia:

i. Virginia Department of Education Claim for Reimbursement dated September 2003 in the amount of $44,057.30;

ii. Virginia Department of Education Claim for Reimbursement dated October 2003 in the amount of $63,074.24;

iii. Virginia Department of Education Claim for Reimbursement dated November 2003 in the amount of $45,689.78;

iv. Virginia Department of Education Claim for Reimbursement dated December 2003 in the amount of 35,952.20;

v. Virginia Department of Education Claim for Reimbursement dated January 2004 in the amount of $39,618.60;

vi. Virginia Department of Education Claim for Reimbursement dated February 2004 in the amount of $46,022.70;

vii. Virginia Department of Education Claim for Reimbursement dated March 2004 in the amount of $64,288.92;

viii. Virginia Department of Education Claim for Reimbursement dated April 2004 in the amount of $56,333.23;

ix. Virginia Department of Education Claim for Reimbursement dated May 2004 in the amount of $56,843.28;

xi. Virginia Department of Education Claim for Reimbursement dated June 2004 in the amount of $21,129.57;

(b) Rutland Public School District of Rutland, Vermont:

i. NSLP and SBP Claim for Reimbursement dated September 2005 in the amount of $56,507.63;

ii. NSLP and SBP Claim for Reimbursement dated October 2005 in the amount of $50,036.82.

(c) Independent School District No. 273 for Edina, Minnesota:

i. NSLP Claim for Reimbursement dated September 2001 in the amount of $2701.76;

ii. NSLP Claim for Reimbursement dated October 2001 in the amount of $2923.20;

iii. NSLP Claim for Reimbursement dated November 2001 in the amount of $2,609.44;

iv. NSLP Claim for Reimbursement dated December 2001 in the amount of $2,239.84 ;

v. NSLP Claim for Reimbursement dated January 2002 in the amount of $2,664.64;

vi. NSLP Claim for Reimbursement dated February 2002 in the amount of $2,614.56;

vii. NSLP Claim for Reimbursement dated March 2002 in the amount of $2,749.76;

viii. NSLP Claim for Reimbursement dated April 2002 in the amount of $2,487.68;

ix. NSLP Claim for Reimbursement dated May 2002 in the amount of 3,191.84;

x. NSLP Claim for Reimbursement dated June 2002 in the amount of $615.60.

(d) Independent School District No. 656 for Faribault, Minnesota:

i. NSLP and SBP Claim for Reimbursement dated September 2004 in the amount of $86,091.71;

ii. NSLP and SBP Claim for Reimbursement dated October 2004 in the amount of $75,182.00;

36. In addition to the scheme of the Sodexho contracts stated above, some of the contracts contained language that originally provided the SFAs would be credited with rebates, discounts, and allowances from food manufacturers and national distributors in whole or in part. However, in the example of Pine Richland SFA, this language was subsequently changed by amendment to allow Sodexho to retain the rebates, discounts, and allowances from food manufacturers and national distributors contradicting the original intentions of the SFAs in accepting Sodexho's bid. For example, the Management Agreement between Pine Richland School District and Sodexho, Inc. provided that, "The SFA shall receive any discounts or rebates for purchases made on their behalf. The FSMC shall purchase all food and non-food commodities at the lower price possible consistent with maintaining quality standards." [Management Agreement, Article XII.B]. This contract was later amended in an Amendment dated June 29, 2004, which provided in relevant part that "operating expenses shall be net of any rebates obtained from local vendors, suppliers, or distributors for goods procured solely for the SFA's account. ***Prompt payment discounts and any***

other rebates or allowances obtained from vendors, suppliers, or distributors, including those obtained through the FSMC's regional or national purchasing or distribution arrangements, will be retained by the FSMC." [Amendment at 2].

37. Upon information and belief, Sodexho invoiced SFAs for costs consistent with the cost reimbursement contracts without crediting the SFAs for the rebates, discounts, and allowances it had obtained from food manufacturers and national distributors. Sodexho invoices paid by SFAs with NSLP and SBP entitlement grant funds that reflected costs that were not net of rebates, discounts and allowances as required by applicable NSLP and SBP rules and Federal regulations. For example, Pine Richland School District paid the following invoices:

(a) Sodexho Invoice # 1000094969 dated February 8, 2005, in the amount of $116,274.40 paid by check # 8041.

(b) Sodexho Invoice # 1000102970 dated March 8, 2005, in the amount of $120,547.10 paid by check # 8045.

(c) Sodexho Invoice # 1000108411 dated April 9, 2005, in the amount of $118,502.22 paid by check # 8051.

(d) Sodexho Invoice # 1000109793 dated May 7, 2005, in the amount of $128,577.11 paid by check # 8055.

(e) Sodexho Invoice # 1000109152 dated June 7, 2005, in the amount of $107,573.09 paid by check #8061.

(f) Sodexho Invoice # 1000124488 dated July 9, 2005 in the amount of $16,386.41 paid by check #8067.

39. By invoicing SFAs and receiving payment from NSLP and SBP entitlement grant funds for costs that were not net of rebates received from food manufacturers and national distributors, Sodexho caused false certifications of compliance with applicable NSLP and SBP rules and Federal regulations and the Agreements between SFAs and SAs to be presented to the United States in connection with accessing NSLP and SBP entitlement grant funds. Sodexho's SFA customers obtained NSLP and SBP entitlement grant funds by filing Claims for Reimbursement falsely certifying compliance with applicable NSLP and SBP program regulations and Federal regulations when in fact, the costs Sodexho was charging the SFAs were neither net of rebates nor procured in a manner providing full and open competition as required. For example, Pine Richland School District presented the following Claims for Reimbursement:

(a) NSLP and SBP Claims for Reimbursement dated August 2004 in the amount of $3,708.16;

(b) NSLP and SBP Claims for Reimbursement dated September 2004 in the amount of $17,813.82;

(c) NSLP and SBP Claims for Reimbursement dated October 2004 in the amount of $18,809.99;

(d) NSLP and SBP Claims for Reimbursement dated November 2004 in the amount of $15,219.33;

(e) NSLP and SBP Claims for Reimbursement dated December 2004 in the amount of $15,400.69;

(f) NSLP and SBP Claims for Reimbursement dated January 2005 in the amount of $17,079.76;

(g) NSLP and SBP Claims for Reimbursement dated February 2005 in the amount of $16,990.43;

(h) NSLP and SBP Claims for Reimbursement dated March 2005 in the amount of $16,187.62;

(i) NSLP and SBP Claims for Reimbursement dated April 2005 in the amount of $19,254.11;

(j) NSLP and SBP Claims for Reimbursement dated May 2005 in the amount of $18,118.10.

40. Although most of Sodexho's contracts with SFAs contained language substantially similar to that set forth above stating that Sodexho would retain rebates, in certain instances, Sodexho's contracts with SFAs represented that rebates, discounts and allowances would be returned to SFAs. For example,

(a) Sodexho's July 1, 2001, contract with the Sierra Vista, Arizona Public Schools Unified District No. 68, with the option of four additional terms of one school year each by mutual agreement,

stated in relevant part that: (i) "Sodexho agrees that it will perform the work described in this agreement in full compliance with all applicable laws, rules, and regulations adopted or promulgated by any federal or state regulatory body or governmental agency" [Article 2.2(B)]; (ii) "Sodexho agrees to meet all requirements and performance standards that may be specified by rule or regulation by any administrative officials or bodies charged with enforcement of any state or federal laws on the subject matter of this agreement" [Article 2.2(C)]; and (iii) "All refunds/rebates for all food/non food items shall be property of the District and deposited as a separate deposit from sales into the food service bank account" [Article 6.1(B)(2)]. Nevertheless, upon information and belief, in violation of the contract, Sodexho has failed to credit Sierra Vista with any rebates it has received from national manufacturers, vendors, and distributors. No such rebates were reflected on invoices sent by Sodexho to Sierra Vista. According to an administrative secretary at Sierra Vista knowledgeable about Sodexho's agreement with the school district, Sierra Vista has not seen a credit for a rebate in the fifteen years that Sodexho has been the FSMC for the district.

(b) Sodexho's Management Agreement dated July 1, 1998, with the Belton School District #124 in the city of Belton, Missouri, which was later extended through June 2003 by amendment dated September 21, 2002. Although the Management Agreement originally contained the language set forth above in

par. 31 stating that Sodexho would retain rebates, the Amendment changed this language to state as follows: "The invoice amounts to Sodexho of goods, including food, beverages, merchandise, supplies, plus a Charge for procurement services equal to $065 [sic] per Pattern Meal and Meal Equivalent. Rebates or allowances obtained from vendors, suppliers, or distributors, including those obtained through Sodexho's regional or national purchasing or distribution agreements as a direct result of purchases made on behalf of District, will be credited to the Food Service Account." [Amendment dated September 21, 2002 at 1.] Nevertheless, upon information and belief, in violation of the contract, Sodexho has failed to credit Belton School District with any rebates it has received from national manufacturers, vendors, and distributors. No such rebates were reflected on invoices sent by Sodexho to Belton.

41. Sodexho knew, or recklessly disregarded, that its failure to credit Sierra Vista and Belton with rebates Sodexho received from national manufacturers, distributors and suppliers caused the SFAs to falsely certify compliance with applicable NSLP rules and Federal regulations in accessing Federal funds. For example:

(a) The RFP for the Sierra Vista Public Schools Unified District ("SVPSUD"), in Sierra Vista, Arizona, dated March 12, 2001, informs bidders that:

> ***The Code of Federal Regulations (CFR) provides rules that SVPSUD must***

> ***observe if they are to participate in the NSLP, the SBP, the SMP, and other meal programs. All contracts should require that FSMC conduct program operations in accordance with 7 CFR Parts 210, 215, 220, 245, 250 and FCS instructions and policies as applicable.*** Incorporation of program regulations provides a common basis for performance by the FSMC.

Section VIII.M. (emphasis added). Additionally, the RFP further states:

> Reporting, 210.16(c)(1) – The FSMC must report the claim information to SVPSUD promptly at the end of each month or more frequently as specified by SVPSUD. All credits received by the FSMC must be credited back to the district. The FSMC shall assume liability for any negligence for claims assessed as a result of federal/state review/ audits corresponding with SVPSUD period of liability. ***All refunds and/or credits received for food/non food items must be noted on the monthly invoices and district administration must be informed***.

Section VIII.F. (emphasis added).

(b) The Belton School District #124 for the city of Belton, Missouri issued an RFP on April 14, 1998 for the 1998-1999 school year which informed bidders: (i) "[The Management FSMC] shall agree to strictly observe all applicable State and Federal statutes, rules, regulations which now exist or which may be promulgated during the term of this

agreement of [sic] extension thereof, i.e. Current Federal regulations 7 CFR Part 210, Sections 210.1 thru 16, and Sections 210.21 thru 23, including 7 CFR 3015 and Attachment O of OMB Circular A-102, are considered part of this Contract." [Legal Requirements/Responsibilities, Section III]; and (ii) "The [Belton School District] shall ensure that all goods, services, or monies received as the result of a rebate will be utilized in the DISTRICT'S [sic] nonprofit food service." [Legal Requirements/ Responsibilities, Section III].

42. Defendant Sodexho answered the RFPs from Sierra Vista and Belton School District and was awarded the contracts as the FSMC for the districts.

43. Upon information and belief, Sodexho invoiced the Sierra Vista and Belton SFAs for costs without crediting them for the rebates, discounts and allowances Sodexho had obtained from food manufacturers and national distributors (no such rebates were reflected on the invoices). Upon information and belief, Sodexho invoices paid by Sierra Vista and Belton with NSLP and SBP entitlement grant funds that reflected costs that were not net of rebates, discounts and allowances as required by applicable NSLP and SBP rules and Federal regulations include, but are not limited to, the following:

(a) Sierra Vista Public Schools Unified District:

i. Sodexho Invoice # 1000071745 dated August 7, 2004 in the amount of $15,210.01 paid by check # 20853.

ii. Sodexho Invoice # 1000074749 dated September 8, 2004 in the amount of $123,571.48 paid by check # 21677.

iii. Sodexho Invoice # 1000076591 dated November 6, 2004 and 1000080711 dated October 9, 2004 in the amounts of $137,530.21 and $199,621.66, respectively, paid by check # 23013 in the amount of $337, 251.87.

iv. Sodexho Invoice # 1000090060 dated January 8, 2005 and 1000088521 dated December 4, 2004 in the amounts of $120,919.70 and $154,374.90, respectively, paid by check # 23932 in the amount of $275,294.60.

v. Sodexho Invoice # 1000099915 dated February 8, 2005 in the amount of $167,731.83 paid by check # 24770.

vi. Sodexho Invoice # 1000102218 dated March 8, 2005 in the amount of $177,687.25 paid by check # 25172.

vii. Sodexho Invoice # 1000111944 dated May 7, 2005 and 1000107213 dated April 9, 2005 in the amounts of $176,944.13 and $155,446.45, respectively, paid by check # 26360 in the amount of $332,390.58.

viii. Sodexho Invoice # 1000125009 dated July 13, 2005 and 1000119701 dated June 7, 2005 in the amounts of $40,343.86 and $161,630.13, respectively, paid by check # 27399 in the amount of $201,973.99.

(b) Belton, Missouri School District:

i. Sodexho Invoice # 316018 dated March 10, 2003, in the amount of $131,646.11 paid by check # 37269.

ii. Sodexho Invoice # 314260 dated February 10, 2003, in the amount of $130,558.50 paid by check # 36672.

iii. Sodexho Invoice # 312477 dated January 14, 2003, in the amount of $106, 150.49 paid by check # 35904.

iv. Sodexho Invoice # 310675 dated December 11, 2002, in the amount of $116,024.20 paid by check # 35211.

v. Sodexho Invoice # 307390 dated November 11, 2002, in the amount of $165,542.29 paid by check # 34352.

vi. Sodexho Invoice # 305607 dated October 14, 2002, in the amount of $147,637.16 paid by check # 33540.

vii. Sodexho Invoice # 305296 and 305295 dated September 11, 2002, in the amounts of $9003.73 and $82,821.49, respectively, paid by check # 32416.

viii. Sodexho Invoice # 300317 dated July 15, 2002, in the amount of $37,937.19 paid by check # 31192.

ix. Sodexho Invoice # 300316 dated July 15, 2002, in the amount of $7,132.33 paid by check # 31191.

x. Sodexho Invoice # 1000007017 dated April 17, 2003, in the amount of $129,904.16 paid by check # 38317.

44. By invoicing Sierra Vista and Belton and receiving payment from NSLP and SBP entitlement grant funds for costs that were not net of rebates received from food manufacturers and national distributors, Sodexho caused false certifications of compliance with applicable NSLP and SBP rules and Federal regulations and the Agreements between SFAs and SAs that were presented to the United States in connection with accessing NSLP and SBP entitlement grant funds. Upon information and belief, SFAs contracting with Sodexho including, but not limited to, those set forth above, obtained NSLP and SBP entitlement grant funds by filing Claims for Reimbursement falsely certifying compliance with applicable NSLP and SBP program rules and Federal regulations and the terms of the Agreements when, in fact, the costs Sodexho was charging the SFAs were neither net of rebates (and thus were effectively equivalent to the prohibited "cost-plus-a-percentage-of-cost" contract) nor, as set forth more fully below, procured in a manner providing full and open

competition as required. Claims for Reimbursement including such false certifications caused by Sodexho include, but are not limited to, the following:

(a) Sierra Vista Public Schools Unified District

i. NSLP and SBP Claim for Reimbursement dated August 2004 in the amount of $76,164.74;

ii. NSLP and SBP Claim for Reimbursement dated September 2004 in the amount of $120,693.02;

iii. NSLP and SBP Claim for Reimbursement dated October 2004 in the amount of $87,053.48;

iv. NSLP and SBP Claim for Reimbursement dated November 2004 in the amount of $108,216.74;

v. NSLP and SBP Claim for Reimbursement dated December 2004 in the amount of $66,533.38;

vi. NSLP and SBP Claim for Reimbursement dated January 2005 in the amount of $106,878.27;

vii. NSLP and SBP Claim for Reimbursement dated February 2005 in the amount of $104,241.14;

viii. NSLP and SBP Claim for Reimbursement dated March 2005 in the amount of $90,361.50;

ix. NSLP and SBP Claim for Reimbursement dated April 2005 in the amount of $114,115.94;

x. NSLP and SBP Claim for Reimbursement dated May 2005 in the amount of $92,554.50.

(b) Belton, Missouri School District:

i. NSLP and SBP Claim for Reimbursement dated September 10, 2002 signed by G. Crabtree in the amount of $14,687.46;

ii. NSLP and SBP Claim for Reimbursement dated October 14, 2002 signed by G. Crabtree in the amount of $54,315.85;

iii. NSLP and SBP Claim for Reimbursement dated November 11, 2002 signed by G. Crabtree in the amount of $64,647.67;

iv. NSLP and SBP Claim for Reimbursement dated December 5, 2002 signed by G. Crabtree in the amount of $42,301.70;

v. NSLP and SBP Claim for Reimbursement dated January 10, 2003 signed by G. Crabtree in the amount of $40,812.37;

vi. NSLP and SBP Claim for Reimbursement dated February 6, 2003 signed by G. Crabtree in the amount of $48,506.80;

vii. NSLP and SBP Claim for Reimbursement dated March 7, 2003 signed by G. Crabtree in the amount of $50,750.95;

viii. NSLP and SBP Claim for Reimbursement dated April 7, 2003 signed by G. Crabtree in the amount of $52,137.49;

ix. NSLP and SBP Claim for Reimbursement dated May 12, 2003 signed by G. Crabtree in the amount of $58,597.29;

x. NSLP and SBP Claim for Reimbursement dated April 11, 2003 signed by G. Crabtree in the amount of $56,467.26.

45. Compliance with NSLP and SBP rules and applicable Federal regulations was a necessary prerequisite of SAs and SFAs for participating in and obtaining Federal NSLP and SBP funds.

46. The SFAs, contracts, RFPs, invoices, checks and claims identified in the foregoing paragraphs are by way of example only. Relator possesses voluminous, additional documents of this nature involving other SFAs evidencing Sodexho's wrongdoing as alleged herein that can be added to an amended pleading if necessary.

2. ARAMARK

47. Hundreds of cost-reimbursable contracts between Aramark and SFAs during the relevant period expressly provided that Aramark would retain rebates, discounts and allowances from food manufacturers and national distributors in whole or in part. Aramark's contracts with SFAs contained substantially identical provisions with respect to rebates, discounts and allowances stating: "Aramark, as an authorized agent of the District, shall purchase and pay for, as a Direct Cost, all food, supplies and services utilized in District's Food Service Program. . . . Aramark will credit all local trade discounts to District's account. ***Cash discounts or discounts not exclusively related to District's Food Service Program shall not be credited to District's account.***"

48. Aramark contracts containing the foregoing language include, but are not limited to, the following:

(a) Food Services Management Agreement dated July 30, 2001 between Aramark Educational Services, Inc. and the Board of Education for the School District of Springfield, Missouri for the 2001-2002 school year with the option of four additional terms of one school year each by mutual agreement of the District and Aramark;

(b) Food Services Management Agreement dated February 2000 between Aramark Educational Services, Inc. and the Central Falls, Rhode Island

School District for the 1999-2000 school year with the option of four additional terms of one school year each by mutual agreement of the District and Aramark;

(c) Food Services Management Agreement beginning July 1, 2004 between Aramark Educational Services, Inc. and the New Haven, Connecticut Board of Education for the 2004-2005 school year with the option of four additional terms of one school year each by mutual agreement of the District and Aramark;

(d) Food Services Management Agreement dated April 2003 between Aramark Educational Services, Inc. and the Lake Havasu City, Arizona Unified School District for the period July 1, 2002-June 30, 2003 with the option of four additional terms of one school year each by mutual agreement of the District and Aramark;

(e) Food Services Management Agreement dated April 11, 2000 between Aramark Educational Services, Inc. and North Haven, Connecticut Public Schools for the 2000-2001 school year with the option of four additional terms of one school year each by mutual agreement of the District and Aramark;

(f) Food Services Management Agreement dated July 28, 2003 between Aramark Educational Services, Inc. and the San Juan School District in Blanding, Utah for the 2003-2004 school year with the option of four additional terms of one school year each by mutual agreement of the District and Aramark;

49. Aramark knew, or recklessly disregarded, that its retention of rebates, discounts and allowances caused false claims to be submitted to the United States. The cost-reimbursable contracts in question were awarded to Aramark based on its responses to Requests for Proposal ("RFPs") issued by SFAs, which made clear that SFAs were to receive all rebates and discounts, and mandated FSMC proposal and contract compliance with all applicable NSLP and SBP rules and Federal regulations. For example:

(a) The RFP dated February 19, 2001 issued by the School District of Springfield, Missouri stated that "The food service program shall be self-supporting and a no-cost operation for the District, [and] shall meet all requirements of the National School Lunch and School Breakfast Programs of the United States Department of Agriculture . . . " [Specifications 1(a)];

(b) RFP # 24-01-313 issued by the City of New Haven issued in January 2004 stated that: (i) "The FSMC shall comply with all state, local, and federal laws and regulations, including those requirements and regulations adopted by the Commissioner of Education and the United States Department of Agriculture and any conditions or amendments thereto" [Section 4.8]; and (ii) "The FSMC shall purchase all food and non-food commodities at the lowest price possible, consistent with maintaining quality standards" [Section 13.1].

(c) RFP No. 01-02-05 issued by the Lake Havasu, Arizona Unified School District #1 stated that "financial incentives that do not accrue to the nonprofit school food service account cannot be used to determine the price submitted" [Instruction 14(f)], and specified that the contract "must be written and conform to all requirements and regulations pertaining to the National School Lunch and National School Breakfast Programs" [Conditions and Specifications Section 2(K)].

(d) RFP dated November 1, 1999 issued by North Haven, Connecticut Board of Education stated that: (i) "The FSMC shall comply with the rules and regulations of the Commissioner of Education and the United States Department of Agriculture, and any additions or amendments thereto" [Section 14(J)]; and (ii) "The FSMC shall purchase all food and non-food commodities at the lowest price possible, consistent with maintaining quality standards" [Section 19(A)].

(e) The RFP dated March 17, 2003 issued by the San Juan School District in Blanding, Utah provided that: (i) "The FSMC shall conduct the program operations in accordance with 7 C.F.R. Parts 210, 215, 220, 245 and FCS instructions and policy as currently prescribed and in accordance with any additions or amendments thereto" [Section 10.10]; and (ii) "All costs charged to the SFA must be net of all discounts, rebates, and allowances received by the FSMC. This cost reduction[ ] must be shown on

monthly invoices or operating statements as a credit to the amount billed" [Section 16.5].

50. Upon information and belief, Aramark invoiced SFAs for costs consistent with the terms of the aforementioned cost-reimbursable contracts and other cost-reimbursable contracts without crediting the SFAs for the rebates, discounts and allowances it had obtained from food manufacturers and national distributors (no such rebates were reflected on invoices). Upon information and belief, Aramark invoices paid by SFAs with NSLP entitlement grant funds that reflected costs that were not net of rebates, discounts and allowances as required by applicable NSLP rules and Federal regulations include, but are not limited to, the following:

(a) Springfield, Missouri Public Schools: Aramark Invoice # 441943 dated October 25, 2005 (for month of September 2005) in the amount of $614,441.76;

(b) Central Falls, Rhode Island Public School District:

i. Aramark Invoice # 480840 dated July 30, 2004 in the amount of $29,587.25 paid by check # 1635.

ii. Aramark Invoice # 480841 dated August 27, 2004 in the amount of $22,896.75 paid by check # 1639.

iii. Aramark Invoice # 34660001 dated September 30, 2004 in the amount $24,214.58 paid by check # 1645.

iv. Aramark Invoice # 480842 dated October 1, 2004 in the amount of $146,132.00 paid by check # 1646.

v. Aramark Invoice # 480843 dated October 29, 2004 in the amount of $136,670.75 paid by check # 1655.

vi. Aramark Invoice # 40843-44 and 48045 dated November 26, 2004, and December 31, 2004, in the amounts of $108,045.09 and $118,069.85 paid by check # 1660 in the amount of $226,114.94.

vii. Aramark Invoice # 480847 and 480848 dated January 28, 2005, and February 25, 2005, in the amounts of $110,980.33 and $119,112.85, respectively, paid by check # 1666 in the amount of $230,093.18.

viii. Aramark Invoice # 480849 and 480850 dated March 2005 and April 1, 2005, in the amounts of and $139,136.77 and $105,846.17, respectively, paid by check # 1668 in the amount of $244,982.94.

ix. Aramark Invoice # 480851 dated May 27, 2005 in the amount of $137,194.30 paid by check # 1671 in the amount of $59,092.23 and check # 1673 in the amount of 78,102.07.

(c) New Haven, Connecticut School District: Aramark Invoice # KC00652337 in the amount of $451,920.82 paid by check # 75381.

(d) North Haven, Connecticut School District:

i. Aramark Invoice # KC00651473 dated October 12, 2004 in the amount of $ 113,159.96 paid by check # 100290.

ii. Aramark Invoice # KC00652350 dated November 18, 2004 in the amount of $100,454.76 paid by check # 100300.

(e) San Juan School District, Blanding Utah:

i. Aramark Invoice # 427038 dated February 5, 2004 in the amount of $75,487.66 paid by check # 51875;

ii. Aramark Invoice # 427039 dated February 27, 2004 in the amount of $70,685.99 paid by check # 52506;

iii. Aramark Invoice # 427040 dated April 2, 2004 in the amount of $86,390.03 paid by check # 53379.

51. By invoicing SFAs and receiving reimbursement for costs that were not net of rebates received from food manufacturers and national distributors, Aramark caused false certifications of compliance with applicable NSLP and SBP rules and Federal regulations and the Agreements between SFAs and SAs to be submitted to the United States in

connection with accessing NSLP and SBP entitlement grant funds. Upon information and belief, SFAs contracting with Aramark, including, but not limited to, those set forth above, obtained NSLP and SBP entitlement grant funds by filing Claims for Reimbursement falsely certifying compliance with applicable NSLP and SBP program rules and Federal regulations and the terms of the Agreements when, in fact, the costs Aramark was charging the SFAs were neither net of rebates (and thus were effectively equivalent to the prohibited "cost-plus-a-percentage-of-cost" contracts) nor, as more fully set forth below, procured in a manner providing full and open competition as required. Claims for Reimbursement including such false certifications caused by Aramark include, but are not limited to, the following:

(a) Springfield, Missouri School District: NSLP and SBP Claim for Reimbursement for month of September 2005 in the amount of $413682.60 and $112,478.74, respectively.

(b) Central Falls, Rhode Island School District:

i. NSLP and SBP Claim for Reimbursement dated September 1, 2004 in the amount of $129,091.77.

ii. NSLP and SBP Claim for Reimbursement dated October 1, 2004 in the amount of $119,387.26

iii. NSLP and SBP Claim for Reimbursement dated November 1, 2004 in the amount of $113,237.18.

iv. NSLP and SBP Claim for Reimbursement dated December 1, 2004 in the amount of $101,954.86.

v. NSLP and SBP Claim for Reimbursement dated January 1, 2005 in the amount of $114,070.20.

vi. NSLP and SBP Claim for Reimbursement dated February 1, 2005 in the amount of $101,769.80.

vii. NSLP and SBP Claim for Reimbursement dated March 1, 2005 in the amount of $144,740.53.

viii. NSLP and SBP Claim for Reimbursement dated April 1, 2005 in the amount of $91,127.92.

ix. NSLP and SBP Claim for Reimbursement dated May 1, 2005 in the amount of $136,721.04.

x. NSLP and SBP Claim for Reimbursement dated June 1, 2005 in the amount of $94,785.73.

(c) New Haven, Connecticut School District: Claim for Reimbursement for the month of October 2004 in the amount of $746,276.79.

(d) San Juan School District, Blanding, Utah:

i. NSLP Claim for Reimbursement dated February 4, 2004 signed by Rhea Laws in the amount of $81,730.18;

ii. NSLP Claim for Reimbursement dated March 3, 2004 signed by Rhea Laws in the amount of $91,420.79;

iii. NSLP Claim for Reimbursement dated April 2, 2004 signed by Rhea Laws.

52. Compliance with NSLP and SBP rules and applicable Federal regulations was a necessary prerequisite of SAs and SFAs for participating in and obtaining Federal NSLP and SBP funds.

53. The SFAs, contracts, RFPs, invoices, checks and claims identified in the foregoing paragraphs are by way of example only. Relator possesses voluminous, additional documents of this nature involving other SFAs evidencing Aramark's wrongdoing as alleged herein that can be added to an amended pleading if necessary.

3. CHARTWELLS

54. Upon information and belief, Chartwells entered into hundreds of cost-reimbursable contracts with SFAs pursuant to which Chartwells retained rebates, discounts and allowances from food manufacturers. Chartwells' contracts with SFAs including,

but not limited to, those set forth below, made clear that rebates were to be retained by the school districts and that the lowest reasonable price should be obtained for food purchased on the SFAs' behalf, and promised that applicable Federal regulations including those set forth above would be strictly observed. For example:

(a) The Poplar Bluff School District' [sic] July 1, 2003 agreement with Chartwells stated that: (i) "Chartwells agrees to strictly observe all applicable State and Federal statutes, rules and regulations which now exist or which may be promulgated during the term of this agreement or extension thereof; i.e., 'Current Federal Regulations 7 CFR Part 210, Sections 210.1 through 16. And sections 210.21 thru 23, including CFR 3015, Subpart S,' as well as with the applicable provisions of the National School Lunch Act as amended, the School Breakfast Program and the Department of Agriculture regulations set forth in 7 CFR 220, 7 CFR 245, 7 CFR 250 and any requirements imposed by any applicable state agency" [Food Service Agreement, Article 1.2]; (ii) "Chartwells must competitively procure all acquisitions funded in whole or in part with nonprofit food service account funds. Chartwells agrees to purchase all food for the SFA at the lowest prices possible consistent with maintaining the quality standards prescribed by the SFA, including taking advantage of all local trade discounts. All procurement transactions must meet procurement standards set by the United States Department of Agriculture.

Transactions shall be conducted in a manner so as to provide maximum open and free competition, as provided by law" [Food Service Agreement, Article 7.2]; (iii) "All goods, services or moneys received as a result of a commodity rebate, to include rebate payments for processed donated foods, will be utilized in the SFA's nonprofit food service" [Article 7.3] ; (iv) "Chartwells shall invoice the SFA monthly a sum not to exceed the amount necessary to cover Chartwells' expenditures for the food service operation" [Article 9.5]; and (v) "Costs charged to the SFA are reimbursable only to the extent that they are allowable costs" [Article 10.2].

(b) The June 10, 1999 agreement between Chartwells and the Board of Education of Mahtomedi, Minnesota Public Schools provided that: (i) "In managing the food service operation, Chartwells shall comply with the applicable provisions of the National School Lunch Act, as amended, and the United States Department of Agriculture ("USDA") regulations set forth in 7 C.F.R. 210 . . . and all other applicable laws, ordinances, regulations and rules of federal, state and local authorities" [Article 1]; and (ii) "Chartwells shall purchase all food for the District as a direct cost of operation at the lowest prices possible consistent with maintaining the quality standards prescribed by the District . . . Preference will be given to local suppliers wherever practical. Chartwells will take advantage of all local trade discounts, and prices negotiated for

local billing will be at levels at least as favorable as prices otherwise available in the area" [Article 8].

(c) Article 10.1 of the June 7, 2005 Food Service Program Management Agreement between Chartwells and the Madison Board of Education provides that: "Chartwells shall comply with all applicable laws, ordinances, rules and regulations relating to Food Service sanitation, safety and health, including, but not limited to, the following: A. National School Lunch Program (in particular Title 7, Code of Federal Regulations Section 210, 245, et seq.). . . ."

(d) The cost-reimbursable contract between Chartwells and the Farmington, Minnesota SFA provides that: (i) "The SFA shall receive any discounts or rebates for purchases made on their behalf" [Section XII.B] and (ii) "the FSMC shall comply with the rules and regulations of the CFL and the USDA, and any additions or amendments thereto, including but not limited to, 7 CFR Parts 210, 215, 220, 245, and 250 and 225, if applicable.." [Section I.K]

(e) The June 30, 2001 cost-reimbursable contract between Chartwells and the Wilton, Connecticut, SFA provides that: (i) "Chartwells will purchase all food for the SFA at the lowest prices possible consistent with maintaining the quality standards prescribed by the SFA, including taking advantage of all local trade discounts" [Article 7.2]; and (ii) "Chartwells shall comply with the applicable provisions of the National School Lunch Act as

amended, the School Breakfast Program and the Department of Agriculture regulations set forth in 7 CFR 210, 7 CFR 220, 7 CFR 245, 7 CFR 250 and any requirements imposed by an applicable state agency" [Article 1.2].

55. Chartwells knew, or recklessly disregarded, that its retention of rebates, discounts and allowances caused false claims to be submitted to the United States. The cost-reimbursable contracts in question were awarded to Chartwells based on its responses to Requests for Proposal ("RFPs") issued by SFAs, which made clear that SFAs were to receive all rebates and discounts, and mandated proposal ad [sic] contract compliance with all applicable NSLP and SBP rules and Federal regulations. For example:

(a) The Poplar Bluff R-1 School District RFP for School Food Service Management for the 2003-2004 school year stated that: (i) "The food service provided shall be operated and maintained as a benefit to the District students, faculty and staff and not as a source of profit to the FSMC;" [Section II.E.2.c] (ii) "The FSMC agrees to strictly observe all applicable State and Federal statutes, rules and regulations which now exist or which may be promulgated during the term of this agreement or extension thereof; i.e., "Current Federal Regulations 7 CFR Part 210, Sections 210.2 through .16, and Sections 210.21 through .23, including 7 CFR 3015, Subpart S;" [Section II.E.2.f] (iii) "The food service program shall meet all requirements of the National School Lunch and School Breakfast Programs of the

United States Department of Agriculture. . . . Costs charged to the District are reimbursable only to the extent that they are allowable costs, net of all credits, discounts or rebates" [Section III.A].

(b) The Madison, Connecticut Public Schools' RFP dated March 14, 2005, stated that: (i) "The FSMC shall comply with all laws, rules, regulations and policies of federal, state and local governments . . . including but not limited to . . . The National School Lunch Act (42 U.S.C. § 1751 *et seq*) . . . [and] 7 CFR Parts 210, 215, 220, 235, 245 and 250 and any additions or amendments thereto" [Section II.A.12]; (ii) "The FSMC shall purchase all food and non-food commodities at the lowest price possible consistent with maintaining quality standards. The SFA shall receive any discounts or rebates for purchases made on their behalf" [Section II.M]; and (iii) "The FSMC shall be responsible for purchasing standards and specifications to bring about the best quality and price for the SFAs food service program. . . . The FSMC shall adhere to procurement standards specified by federal, state and local laws, rules, regulations and policies" [Section II.M].

(c) A 2004 RFP issued by the Farmington, Minnesota Independent School District provided that: (i) "Reimbursement for cost of goods will be the actual purchases as documented by invoices less all discounts and rebates taken by the company. Where rebates are not made directly to the FSMC without designation made to specific FSMC accounts, the FSMC will prorate the discount and credit the SFA"

[General Information, Section M]; (ii) The FSMC shall comply with the rules and regulations of the . . . USDA, and any additions or amendments thereto, including but not limited to, 7 CFR Parts 210, 215, 220, 245 and 250 and 225, if applicable . . . " [Section I.K]; and (iii) "The SFA shall receive any discounts or rebates for purchases made on their behalf" [Section XII.B].

56. Upon information and belief, Chartwells invoiced SFAs for costs without crediting the SFAs for the rebates, discounts and allowances it had obtained from food manufacturers and national distributors (no such rebates were reflected on invoices). Upon information and belief, Chartwells' invoices paid by SFAs with NSLP and SBP entitlement grant funds that reflected costs that were not net of rebates, discounts and allowances as required by applicable NSLP and SBP rules and Federal regulations include, but are not limited to, the following:

(a) Poplar Bluff School District:

i. Chartwells Invoice # X080750204 dated October 31, 2003 in the amount of $174,128.68;

ii. Chartwells Invoice # X080750304 dated November 30, 2003 in the amount of $154,552.02;

(b) Mahtomedi, Minnesota Public Schools: Chartwells Invoice dated October 1999 in the amount of $79,724.74 paid by check # 65448;

(c) Madison, Connecticut Public Schools: Chartwells Invoice # X164950106 dated September 30, 2005 in the amount of $87,962.82 paid by check # 41918.

(d) Farmington, Minnesota Public Schools:

i. Chartwells Invoice # X129350205 dated October 31, 2004, in the amount of $159,789.10;

ii. Chartwells Invoice # X129350305 dated November 30, 2004, in the amount of $178,377.68;

57. By invoicing SFAs and receiving reimbursement for costs that were not net of rebates received from food manufacturers and national distributors, Chartwells caused false certifications of compliance with applicable NSLP and SBP rules and Federal regulations and the terms of the by [sic] Agreements between SFAs and SAs to be submitted to the United States in connection with accessing NSLP and SBP entitlement grant funds. Upon information and belief, Chartwells' SFA customers, including, but not limited to, those set forth above, obtained NSLP and SBP entitlement grant funds by filing Claims for Reimbursement falsely certifying compliance with applicable NSLP and SBP program rules and Federal regulations and the terms of the Agreements when, in fact, the costs Chartwells was charging the SFAs were neither net of rebates (and thus were effectively equivalent to the prohibited "cost-plus-a-percentage-of-cost" contract) nor, as more fully set forth below, procured in a manner providing

full and open competition as required. In certain instances, pursuant to Chartwells' contract with the SFAs, these Claims for Reimbursement were prepared by Chartwells for the SFAs signature. Claims for Reimbursement including such false certifications caused by Chartwells include, but are not limited to, the following:

(a) Poplar Bluff School District:

i. NSLP and SBP Claim for Reimbursement dated November 17, 2003, submitted by E. Lawson, in the amount of $138,777.08;

ii. NSLP and SBP Claim for Reimbursement dated December 15, 2003, submitted by E. Lawson, in the amount of $118,895.02;

(b) Mahtomedi, Minnesota Public Schools:

i. NSLP Claim for Reimbursement dated September 1999, in the amount of $4,897.79;

ii. NSLP Claim for Reimbursement dated October 1999, in the amount of $5,543.97;

iii. NSLP Claim for Reimbursement dated November 1999, in the amount of $6,075.18;

iv. NSLP Claim for Reimbursement dated December 1999, in the amount of $4,904.63;

v. NSLP Claim for Reimbursement dated January 2000, in the amount of $6,169.90;

vi. NSLP Claim for Reimbursement dated February 2000, in the amount of $6,199.67;

vii. NSLP Claim for Reimbursement dated March 2000, in the amount of $6,008.16;

viii. NSLP Claim for Reimbursement dated April 2000, in the amount of $5,992.35;

ix. NSLP Claim for Reimbursement dated May 2000, in the amount of $6,820.03;

x. NSLP Claim for Reimbursement dated June 2000, in the amount of $1,798.73;

(c) Farmington Minnesota Public Schools:

i. NSLP and SBP Claims for Reimbursement dated October 2004, in the amount of $30,468.76;

ii. NSLP and SBP Claims for Reimbursement dated November 2004, in the amount of $33,640.39.

58. Compliance with NSLP and SBP rules and applicable Federal regulations was a necessary prerequisite of SAs and SFAs for participating in and obtaining Federal NSLP and SBP funds.

59. The SFAs, contracts, RFPs, invoices, checks and claims identified in the foregoing paragraphs are by way of example only. Relator possesses many additional documents of this nature involving other SFAs evidencing Chartwells' wrongdoing as alleged

herein that can be added to an amended pleading if necessary.

B. Defendants' Failure To Seek Competitive Bids

60. Although applicable Federal regulations required all procurement transactions using Federal grant funds to be conducted in a manner providing full and open competition, as a result of their lucrative deals funneled through national distributors, Defendants lacked any incentive to, and did not, seek bids from local distributors. Such local distributors offered the lowest price consistent with quality for food being purchased on behalf of SFAs because they did not offer Defendants rebates on any "rigged spread" like that Defendants arranged through national distributors and were, therefore, able to sell food and supplies to SFAs at prices not inflated by the rigged spread. Local distributors only added their mark-up to their net cost. As a result, Defendants had every incentive to and did purchase food from national distributors who willingly marked up the higher "into distribution price" Defendants negotiated with food manufacturers and, additionally, offered the Defendants the opportunity to obtain rebates for such things as drop size, prompt payment, Web-based ordering and buying goods branded with the distributors' names.

61. Defendants' failure to seek competitive bids from local distributors drained millions of dollars

from the NSLP and SBP programs. For example, the average cost per program lunch for food in Sodexho-managed SFAs in Connecticut was 25% higher than in self-operated districts in Connecticut in 2002-2003 ($0.94 in Sodexho-managed districts as opposed to $0.75 for self-operated Connecticut school districts). Further evidencing the competitive pricing of local distributors over that offered by Defendants, who funneled their purchases through national distributors, Thurston, a local distributor serving Connecticut, Rhode Island, Massachusetts and parts of New Hampshire and New York, won a competitive bid to sell food to self-operated districts in the EastConn, Connecticut buying co-op for the 2006-2007 school year. A comparison of prices for 147 food and supply items purchased by EastConn (using local distributor Thurston or a permitted alternative under the EastConn-Thurston buying agreement) with prices for the same or similar items purchased by Sodexho and Chartwells (using national distributors) on behalf of Sierra Vista, Arizona SFA; Yuma, Arizona SFA; Snowflake, Arizona SFA; Poplar Bluff, Missouri SFA; and Branford, Connecticut SFA, confirms that FSMC prices using a national distributor are routinely higher than those of local distributors. With respect to all but 14 of the 146 items, the price paid by EastConn was lower, sometimes substantially so, than the price charged by Sodexho and Chartwells. For the 14 items as to which EastConn's price was higher, the price differential ranged from a low of 38 cents (for Gatorade) to as much as $5.23 (for breadsticks). With respect to the

133 items as to which Sodexho and Chartwells' prices were higher, the price differential was far more pronounced, ranging from a low of 2 cents (for animal crackers) to a high of $24.92 (for napkins). A total of 26 items as to which Sodexho and Chartwells' prices were higher had a greater price differential than $5.23, which was the largest spread between prices in the few instances in which EastConn's price was higher. With respect to 10 of these 26 items, the price differential was greater than $10.

62. This experience was not unique to Connecticut or the Northeast. According to the Executive Director of Finance for the Norman, Oklahoma School District, when a State audit of the district revealed that Sodexho was not obtaining price quotes when purchasing food for the district, she requested that Sodexho do so. After a year of unanswered requests for bids from Sodexho, Norman obtained bids from Sysco directly, which were lower than the prices Sodexho had been charging the Norman school district using Sysco as its national distributor.

CLAIM FOR RELIEF

VIOLATION OF THE FALSE CLAIMS ACT, 31 U.S.C. § 3729(a)(1) and (2)

63. The allegations contained in paragraphs 1 through 62 above are realleged as if fully set forth herein.

64. As set forth above, by retaining rebates from food manufacturers and national distributors and failing to procure food for their SFA customers in a manner promoting open and fair competition in violation of the NSLP, the SBP and applicable Federal regulations, Defendants (i) knowingly presented, or caused to be presented, to the United States false or fraudulent claims for payment or approval in violation of 31 U.S.C. § 3729(a)(1); and (ii) knowingly made, used or caused to be made or used, a false record or statement to get a false or fraudulent claim paid or approved by the Government in violation of 31 U.S.C. § 3729(a)(2). False certifications by SFAs contained in Claims for Reimbursement submitted to SAs that the claims were in accordance with the terms of the Agreements between the SFAs and SAs and/or applicable Federal regulations mandating compliance with, *inter alia*, 7 C.F.R. §§ 210, 220, 3015 and 3016, were material misrepresentations made to obtain a government benefit. Paying that benefit resulted in funds, that should have remained in the NSLP and SBP programs at SFAs where Defendants were operating, being siphoned off by Defendants, along with Defendants incurring non-competitive prices on behalf of SFAs for food and supplies, as a result of which the federal programs were being operated with far less money than should have remained in the programs to their serious detriment.

65. The claims which are the basis of this cause of action were submitted by Defendants' SFA clients nationwide.

66. Defendants acted knowingly when they caused to be made or used the false records set forth above in order to get a false or fraudulent claim paid or approved by the Government.

67. The United States has been damaged as a result of Defendants' violations of the False Claims Act as Federal entitlement grant money has been paid to Defendants for improper purposes.

PRAYER FOR RELIEF

WHEREFORE, the United States respectfully requests this Honorable Court to enter an Order granting the following relief:

(a) Civil penalties against each Defendant of not less than $5,000 and not more than $11,000 per false claim;

(b) Three times the amount of damages which the United States has sustained because of the acts of the Defendants to be determined at trial;

(c) Reasonable attorneys' fees, costs, and expenses which Relator necessarily incurred in bringing and prosecuting this case, as well as pre- and post-judgment interest;

(d) The Relator be awarded the maximum amount allowed to him pursuant to the FCA; and

(e) Any and all other relief that this Honorable Court deems proper.

DEMAND FOR JURY TRIAL

Plaintiff/Relator demands a trial by jury as to all issues triable by a jury.

Done this 30th day of July, 2007.

Respectfully submitted,

WHATLEY DRAKE & KALLAS, LLC

By: /s/

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CERTIFICATE OF SERVICE

I hereby certify that I have this date served a copy of the foregoing by U.S. mail to the following on this 31st day of July, 2007:

Patrick Meehan, Esq.
Joseph Trautwein, Esq.
United States Attorney's Office
615 Chestnut Street, Suite 1250
Philadelphia, Pennsylvania 19106

I further hereby certify that under the dictates of 18 U.S.C. § 3730(b)(2) and Fed. R. Civ. P. 4(d)(4), the instant Amended Complaint has been served only upon the foregoing party and not upon Defendants Sodexho, Inc., Aramark Corporation, and Compass Group USA, Inc.

/s/
OF COUNSEL

United States General Accounting Office

GAO Report to Congressional Committees

August 1996 SCHOOL LUNCH PROGRAM

Role and Impacts of Private Food Service Companies

[SEAL]

G A O

75 years 1921 – 1996

GAO/RCED 96-217

* * *

Executive Summary

Purpose

Under the multibillion-dollar National School Lunch Program, local school districts receive federal funds for lunches that meet the program's requirements for a nutritious, well-balanced meal. Although these school districts, through their school food authorities, have traditionally operated their own school meals program, a number have contracted with private food service management companies to plan, prepare, and serve school meals. In addition, some schools have purchased brand-name fast foods to serve as part of their school meals or as a la carte items.

In the Healthy Meals for Healthy Americans Act of 1994 (P.L. 103-448), the Congress directed GAO to study the use of private food establishments and caterers by schools participating in the federal programs for school meals. As agreed with the cognizant congressional committees, GAO (1) determined the extent to which food authorities use food service companies to operate their school lunch program and the impacts that the use of food service companies has had on various aspects of the National School Lunch Program; (2) described the terms and conditions in the contracts between food authorities and food service companies; and (3) determined the extent to which fast foods and snack foods in vending machines are available in schools participating in the program and described the types, brands, and nutritional content of the fast foods most commonly offered.

In conducting this review, GAO relied primarily on information contained in (1) 1,175 questionnaires that were returned to GAO by food authorities that had contracts with food service companies in school year 1994-95, (2) 765 questionnaires returned by a national random sample of food authorities that did not use food service companies in that same year, and (3) 1,887 questionnaires returned by a national random sample of public school cafeteria managers. GAO also analyzed a random sample of 68 contracts

Results in Brief

About 8 percent of the food authorities nationwide that participated in the lunch program in school year 1994-95 used food service management companies. This percentage is up from about 4 percent in school year 1987-88, the last year that comparable data were available. Most of the food authorities using food service companies reported that they turned to the companies for financial reasons, such as their belief that using a private company would reduce budget deficits and increase revenues. Compared with those food authorities that did not use food service companies, food authorities using food service companies had about the same situation regarding reported budget deficits but lower levels of students' participation in the lunch program. According to food authorities' responses, most food service workers remained employed either with the school district or the food service company as the result of contracting with a food service company.

Food authorities' contracts with food service companies vary in content and compliance with the federal requirements governing these contracts. Contracts vary by the services provided by the food service company, such as by the types of meals and nutrition education provided, and by the associated fees for those services. In addition, about one-half to two-thirds of the contracts did not contain all the standard contractual provisions necessary to ensure compliance with federal requirements. For example, the provisions most often omitted were those intended to

ensure that the food authorities maintain control of the school meals programs. GAO is concerned that the failure to include some of these provisions in the contracts may diminish compliance.

The results of GAO's survey of cafeteria managers indicates that an estimated 13 percent of the public schools participating in the lunch program offer brand-name fast foods. The most popular types of foods were pizzas, burritos, and subs and other sandwiches. These foods can be incorporated into a school lunch that meets federal requirements. In an estimated 20 percent of the schools, students had access to snack foods and drinks from vending machines during lunch.

Background

In fiscal year 1995, the U.S. Department of Agriculture (USDA) spent about $5.2 billion to provide the nation's school-age children with nutritious foods and promote healthy eating choices through its lunch program. State agencies, usually departments of education, are responsible for the statewide administration of the program, including disbursing federal funds, monitoring the program, and record keeping. Many of these responsibilities are carried out in cooperation with food authorities. Food authorities are responsible for managing school food services for one or more schools or for a school district.

Schools participating in the lunch program receive cash reimbursements and commodities for each meal

served. In turn, they must serve lunches that meet federal nutritional requirements and offer these lunches free or at a reduced price to children from families whose income falls below certain specified levels.

USDA's regulations stipulate that if a food authority contracts with a food service company, the food authority must remain responsible for the overall operation of its food service to ensure that the program is administered in an accountable manner and that all of the program's regulations are met. This responsibility requires the food authority to maintain direct involvement in the food service operation, such as monitoring the food service company's operation through periodic on-site visits.

Principal Findings

Use of Food Service Companies to Manage School Food Services Is Increasing

From school year 1987-88 through school year 1994-95, the number of food authorities participating in the lunch program and contracting with food service companies to operate their schools' food services increased from 4 to 8 percent. These food authorities tend to be larger, on average, in terms of the number of schools for which they are responsible and the number of students enrolled than food authorities that do not use these companies.

Most food authorities using one of these food service companies reported financial considerations, such as their belief that using a company would reduce budget deficits and food service costs as reasons for their decision. For example, 61 percent reported that before using a food service company, their food service operated at a deficit. The food authorities using these companies reported financial improvements, including lower costs for food, payroll, employee benefits, and administration. However, 19 percent of the food authorities reported that they were operating at a deficit after contracting with a food service company, about the same percentage reported by food authorities not using these companies in school year 1995-96. In addition, the food authorities with food service contracts reported increased student participation in the lunch program; however, participation is still below the level for food authorities that did not use these companies – 49 percent compared with an estimated 65 to 68 percent.

After contracting with a food service company, food authorities reported varied impacts on food service workers. Forty-three percent reported that most or all of their workers were retained as employees of the school district. However, 32 percent reported that most or all of their workers lost their jobs with the school district but were rehired by the private company. Most food authorities using these companies reported reductions in personnel-related food service costs.

Food Service Contracts Vary in Content and In Compliance With Selected Federal Requirements

While almost all food authorities' contracts with food service companies state that the company prepares and serves meals, the contracts vary by the types of meals provided, such as breakfast and/or lunch. Moreover, some of the related meal services were assigned to the food authority or shared by both the company and the food authority. For example, most of the contracts assigned the (1) purchasing of food to the company, repair and maintenance of equipment to the food authority, and menu planning jointly to the food authority and the company. In addition, some of the contracts state that the existing food service staff will be retained; most contracts do not mention the retention of existing school staff at all.

Most food service contracts specify a cost-plus-a-fixed-fee payment structure, but fees and other financial provisions vary. For example, fees are for administrative costs, management costs, or both and are calculated on an annual basis, per-meal basis, or both. Many of the contracts stipulate only an annual fee, about half stipulate only a per-meal fee, and some stipulate both types of fees. Food service contracts vary in their treatment of rebates and discounts received by the food service company when it purchases food for the food authorities. Many contracts do not address rebates and discounts, and some allowed the company to keep portions of these discounts.

USDA's guidance for food service contracts specifies a number of provisions that must appear in the contracts to ensure that federal requirements are met. State agencies, according to USDA's guidance, are responsible for reviewing the contracts to ensure that they contain all of the required federal provisions. The provisions that GAO selected for review address financial controls, USDA-donated foods, monitoring and evaluation, and the contracts' duration and renewal. GAO found that about one-half to two-thirds of the food service contracts do not contain provisions for all eight federal requirements reviewed. Moreover, the provisions most often omitted from the contracts were those intended to ensure that the food authority maintains control of the school meals programs. The failure to include some of the required provisions in the contracts may create uncertainty about the food service company's responsibilities and diminish the food authority's ability to ensure that the food service company complies with the lunch program's requirements.

Percentage of Schools Offering Brand-Name Fast Foods Has Increased

The percentage of public schools participating in the lunch program that offered brand-name fast foods increased dramatically from about 2 to 13 percent from school year 1990-91 through school year 1995-96. Among other characteristics, schools that offered brand-name fast foods were more likely to be located in the suburbs, have larger student populations, and

use a food service company. These schools also offered one or two brand-name fast-food items twice a week, on average.

Most schools reported benefits from using brand-name fast foods. Seventy-five percent of the cafeteria managers reported that a desire to increase student participation in the lunch program was one of the reasons their schools decided to offer brand-name fast foods. Consistent with this desire, the most frequently cited benefit was an increase in both school lunch and a la carte sales. Cafeteria managers at schools that were not using brand-name fast foods reported most frequently that they believe the food currently being served by their school was more nutritious.

Federal reimbursements are not provided to schools for brand-name fast-food items served a la carte because, by themselves, they do not meet USDA's nutritional standards. However, meals that include brand-name fast foods and other foods prescribed by the lunch program can be eligible for federal reimbursement. GAO's analysis of available ingredient information for four fast foods – Pizza Hut's pepperoni pizza, Domino's pepperoni pizza, Taco Bell's bean burrito, and Subway's Club sandwich – and the lunch program's requirements show that these items can be incorporated into a reimbursable lunch.

During lunch, students had access to snack foods and/or drinks in most of the schools. Two-thirds of the schools provided items such as juices, baked goods,

and ice cream through a school canteen or a la carte sales during the lunch period. About one in five of the schools made such items available in vending machines.

Recommendation

To achieve improved compliance with USDA's guidance, GAO recommends that the Secretary of Agriculture direct the Administrator, Food and Consumer Service, to work with appropriate state officials to ensure that food service management companies' contracts contain the provisions required by USDA's guidance on contracting with food service management companies.

Agency Comments

GAO provided copies of a draft of this report to the Department's Food and Consumer Service for its review and comment. GAO met with agency officials including the Director of the Grants Management Division. USDA concurred with GAO's recommendation and plans to take action. Planned actions include (1) sending a letter to appropriate state agencies reiterating the importance of including required provisions in food service management contracts and (2) making USDA's guidance for these contracts more readily available by placing it on the agency's automated information system and the Internet. In addition, agency officials provided GAO with some

technical comments that were incorporated into the report as appropriate.

* * *

Chapter 1

Introduction

In fiscal year 1995, the U.S. Department of Agriculture (USDA) spent about $5.2 billion to provide the nation's school-age children with nutritious foods and promote healthy eating choices through its National School Lunch Program.[1] State agencies, usually departments of education, are responsible for the statewide administration of the lunch program through the disbursing of federal funds, monitoring of the program, and record keeping. Many of these responsibilities are carried out in cooperation with local school food authorities. Food authorities are responsible for managing school food services for one or more schools or for a school district.

Schools have traditionally operated their own food services. However, some important changes in the way they provide meals have taken place since the 1980s. Some food authorities have contracted with private food service management companies (FSMC) to operate their school food services. In addition, some schools are offering brand-name fast foods as a part of

[1] The program is authorized under the National School Lunch Act (42 U.S.C. 1751 et seq.).

the lunch program meal or as separate (a la carte) items.

National School Lunch Program

According to USDA, on a typical school day in fiscal year 1996, the lunch program provided about 26 million students with balanced and low-cost or free lunches nationwide. Of these students, about 25 million, or about 96 percent, attended public schools, and about 967,000, or about 4 percent, attended private schools. Within a school district, schools can choose to participate or not participate in the program. During fiscal year 1995, about 94,000 institutions, including about 89,000 schools and about 5,000 residential child care institutions participated in the lunch program, according to USDA.[2] State education agencies usually administer the program through agreements with food authorities. The federal cost to support school lunches in fiscal year 1995 was about $5.2 billion, including about $613 million in federal commodity donations, such as beef patties, flour, and canned vegetables. The lunch program operates in all 50 states, the District of Columbia, and U.S. territories and possessions.

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[2] Residential child care institutions include, but are not limited to, homes for the mentally, emotionally, or physically impaired; temporary shelters for abused or runaway children; and juvenile detention centers.

Schools participating in the lunch program receive cash reimbursements and commodities from the federal government for each meal served. In turn, they must serve lunches that meet federal nutritional requirements and offer these lunches free or at a reduced price to children from families whose income falls below certain levels.[3] For school year 1995-96, schools were reimbursed $1.795 for each free lunch, $1.395 for each reduced-price lunch, and 17.25 cents for each full-pay lunch. In addition, schools received 14.25 cents worth of commodity foods for each lunch served. These lunch program meal reimbursements and donated commodities help to sustain the food services provided by food authorities. However, in some areas, food authorities may incur meal costs that are below or above the lunch program's reimbursements because of food, labor, and other food service-related cost variations, thus creating surpluses or deficits in some food service budgets.[4]

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[3] Children from families with an income at or below 130 percent of the poverty level (currently $20,280 for a family of four in the contiguous 48 states and the District of Columbia) are eligible for free meals. (Special rates apply to Alaska and Hawaii.) Those with an income between 130 percent and 185 percent of the poverty level (currently $28,860 for a family of four) are eligible for reduced-price meals. Children from families with an income over 185 percent of the poverty level pay full price, although their meals are still subsidized to some extent.

[4] See *Food Assistance: Information on Meal Costs in the National School Lunch Program* (GAO/RCED-94-32BR, Dec. 1, 1993).

USDA has developed a "lunch pattern" for five different age and grade categories. (See app. II.) This pattern requires that a school lunch contain five food items chosen from the four basic food groups. The size of the portions varies by these categories; nevertheless each lunch, at a minimum, must contain (1) one serving of a meat or a meat alternate, (2) one serving of a bread or bread alternate, (3) one serving of milk, and (4) two servings of vegetables or fruits.[5] Schools must offer all five food items unless, as provided by the lunch program's regulations, they use the "offer versus serve" option. Under this option, a school must offer all five food items, but a student may decline one or two of them. All high schools must use the "offer versus serve" option, and middle and elementary schools may use it at the discretion of local officials. According to a 1993 report prepared for USDA,[6] 71 percent of elementary schools and 90 percent of middle schools used this option.

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[5] School lunches are intended to provide children with enough nutrients to approximate one-third of the essential Recommended Dietary Allowances. The lunch program's regulations, effective for school year 1996-97, require compliance with the Dietary Guidelines for Americans. Among other things, these guidelines, which represent the official nutritional policy of the U.S. government, establish maximum daily amounts of total fat and saturated fat: No more than 30 percent of calories should come from fat, and less than 10 percent should come from saturated fat. (See 7 C.F.R. 210.)

[6] *The School Nutrition Dietary Assessment Study: School Food Service, Meals Offered, and Dietary Intakes*, Mathematica Policy Research, Inc. (Oct. 1993).

Participating schools also agree to collect data on the number of meals served and are responsible for other tasks, such as verifying the income of families with students to determine whether the students are eligible for free or reduced-price lunches.

According to the American School Food Service Association, school lunch preparation usually occurs at individual or centrally located school kitchens. These facilities are operated by the food authorities or, with their approval, by others, such as FSMCs.

Food Service Management Companies

In 1970, USDA issued regulations permitting food authorities to contract with FSMCs to operate their school food services.[7] Food authorities may contract with FSMCs for many aspects of their school food service. The commercial organizations that typically contract with food authorities to operate food services include large national companies, such as Marriott, Canteen, and ARAMARK; companies operating regionally or at multiple sites in a state; and companies servicing a single school district. The services provided by FSMCs are likely to include some combination of the following management and operational service:

- Food services, including meal planning, food purchasing, storage, preparation, and packaging and serving the food to students.

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[7] 7 C.F.R. 210.16.

- Accounting services and the design of financial controls, budgets, and reporting systems, including those required for state and federal reports.
- The design of facilities, maintenance and replacement of equipment, and cleaning services.
- Staffing and personnel management.
- Support activities, such as marketing and promotion of school meals, and nutrition information and education programs.

USDA's regulations stipulate that if a food authority contracts with an FSMC, the food authority must remain responsible for the overall operation of its food service to ensure that the program is administered in an accountable manner and that all of the program's regulations are met. This responsibility requires the food authority to maintain direct involvement in the food service operation, such as monitoring the food service operation through periodic on-site visits.

Brand-Name Fast Foods

While food authorities have traditionally prepared their own foods for school lunches, many have begun to serve brand-name fast foods in recent years. These foods are ready-to-serve – for example, pizzas, burritos, subs, and sandwiches – and are generally prepared and delivered to schools by fast-food vendors such as Pizza Hut, Domino's Pizza, Taco Bell, and Subway as well as by local vendors. Unlike FSMCs, these vendors usually do not manage schools' food

service operations. Instead, they provide schools with a food product at a specified time. For example, a pizza vendor may agree to provide a school with fresh, hot pizza for lunch on every other Wednesday.

Unless a fast-food vendor operates as an FSMC, USDA does not allow these vendors to sell directly to students at school. Instead, these vendors typically sell their food products to a school or its FSMC, which, in turn, sells the products to the students. Schools can offer brand-name fast foods as part of a reimbursable lunch, as an a la carte item, or both.

Objectives, Scope, and Methodology

In the Healthy Meals for Healthy Americans Act of 1994 (P.L. 103-448), the Congress directed us to study the use of private food establishments and caterers by schools participating in the National School Lunch or School Breakfast Programs.[8] In response to this mandate, and as agreed with the offices of the Senate Committee on Agriculture, Nutrition, and Forestry and the House Committees on Agriculture and on Economic and Educational Opportunities, we (1) determined the extent to which food authorities use FSMCs to operate their food services and the impacts

[8] The Congress directed that we and the Office of Technology Assessment jointly conduct this study. However, the Congress did not provide fiscal year 1996 operational funds for the Office of Technology Assessment. The office ceased operations on September 29, 1995.

that their use has had on various aspects of the lunch program, such as student participation, school food service employment, the generation of revenues through school meal sales, and a la carte sales of food in schools; (2) described the terms and conditions under which schools that participate in the lunch program use FSMCs; and (3) determined the extent to which schools that participate in the lunch program are provided with fast foods and snack foods in vending machines, described the most frequently used types and brands of fast foods commonly offered, and described their nutritional content.

Because our preliminary work demonstrated that developing a nutritional profile of the hundreds of different food products available nationwide to students during school hours would be excessively costly, we discussed this issue with the offices of the cognizant committees. Given the technical complexities of the requirement and the limits on our resources and reporting time frame – our mandate required us to complete our work by September 1, 1996 – we agreed with the cognizant committees to limit our work on the third objective to (1) presenting nutritional information for a sample of popular brand-name fast food products and (2) describing the types of vending machine foods commonly available in schools participating in the lunch program. As further agreed, we limited our review to the lunch program – the largest of USDA's school meals programs.

To address the first objective, we contacted each of the 50 states and the District of Columbia to obtain their school year 1994-95 lists of all food authorities, both public and private, and all food authorities using an FSMC. We then mailed questionnaires to 1,462 food authorities that states had identified as having contracts with FSMCs during the 1994-95 school year. In the course of our review, we identified 75 food authorities that were residential child care institutions, did not participate in the lunch program, or did not have contracts with FSMCs. We excluded these food authorities from the universe of 1,462 food authorities, thereby developing a universe of 1,387 food authorities. Eighty-five percent (1,175) of the remaining 1,387 food authorities returned a completed questionnaire. Hence, our survey results for this group represent only the 1,175 survey respondents that participated in the lunch program and had FSMC contracts during school year 1994-95.

In addition, we mailed questionnaires to a national random sample of 934 of the food authorities that did not have contracts with FSMCs. Of those, 89 percent (835) of the food authorities returned completed questionnaires. However, 70 of the food authorities reported that they did not participate in the lunch program or did use an FSMC during school year 1994-95. These questionnaires were not included in our analysis. We used the responses from the remaining 765 questionnaires to compare food authorities that had FSMC contracts with those that did not. Our survey results represent the views of about 14,801

food authorities that do not have contracts with FSMCs.

To address the second objective, we reviewed relevant federal regulations and USDA's guidance on contracting with FSMCs and collected and analyzed a random sample of 68 food service contracts to identify the selected terms and conditions of these contracts and reviewed relevant federal studies and evaluations of FSMC contracts. The results of our analyses of the 68 contracts can be generalized to about 1,212 of the food authorities participating in the lunch program that had contracts with FSMCs for their school lunch programs during school year 1994-95.

With respect to the third objective, we mailed questionnaires to a national random sample of 2,450 public school cafeteria managers to obtain information on the extent of their use of brand-name fast foods and the availability of snack foods in vending machines in public schools. The results of this survey are presented in our report entitled *School Lunch Program: Cafeteria Managers' Views on Food Wasted by Students* (GAO/RCED-96-191, July 18, 1996). Of this sample, 1,887 cafeteria managers who participated in the lunch program returned a questionnaire. We summarized the data that the respondents provided us with to determine the extent to which brand name fast foods were used in the lunch program and the types of snack foods sold to students a la carte from vending machines or by canteens during lunch. This

information represents the views of cafeteria managers in about 80 percent of the public schools that participated in the lunch program nationwide.

Three of our data collection strategies relied on statistical sampling, including the survey of food authorities not contracting with FSMCs, the selection of contracts between food authorities and FSMCs, and the survey of cafeteria managers. As with all sample surveys, our statistical estimates based on these data collection strategies contain sampling error – the potential error that arises from not collecting data from all food authorities – on all contracts or from cafeteria managers at all schools.

We calculated the amount of sampling error for each estimate at the 95-percent confidence level. This means, for example, that if we repeatedly sampled food authorities from the same universe and performed our analysis again, 95 percent of the samples would yield results within the range specified by our survey estimate plus or minus the sampling error. This range is the 95-percent confidence interval.

We conducted our review from June 1995 through July 1996 in accordance with generally accepted government auditing standards.

* * *

Chapter 3

FSMCs' Contracts Vary in Content and in Compliance With Selected Federal Requirements

Food authorities' contracts with FSMCs vary in content and in compliance with the selected federal requirements from the USDA guidance we reviewed.[1] In addition to stating that FSMCs will prepare and serve school meals, the contracts assign responsibility for other meal-related services such as food purchasing and nutrition education to the FSMC in varying degrees. Furthermore, although most food service contracts state that food authorities will pay FSMCs using a cost-plus-a-fixed-fee payment structure, the types and number of fixed fees vary. Finally, about one-half to two-thirds of the FSMC contracts do not contain all provisions required by USDA's guidance that we reviewed. The required provisions most often not found in the contracts were those intended to ensure that the food authorities maintain control of the school meals programs.

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[1] Federal requirements are based on the program's policies, pertinent regulatory requirements, and guidance as described in *Contracting With Food Service Management Companies: Guidance for School Food Authorities*, Food and Consumer Service, USDA (rev., Apr. 1995, final, June 1995).

Food Authorities Contract for a Variety of Services

While almost all FSMC contracts state that the FSMC is responsible for preparing and serving meals and identify which meals the FSMC will provide, the contracts vary with regard to other related services – such as food purchasing and nutrition education – that they assign to the FSMC. We found that some contracts assign responsibility for related meal services to the FSMC, some to the food authority, and some to both organizations. In addition, while most contracts contain provisions defining responsibilities for managing food service personnel, their treatment of issues affecting the employment of existing personnel varies.

FSMC Contracts Vary in Types of Meals Provided

Our review indicates that almost all contracts state that the FSMC is responsible for preparing and serving meals. In addition, about 91 (84 to 98) percent of the contracts state that the FSMC will provide lunch, and 69 (58 to 80) percent state that the FSMC will provide breakfast. We also found that contracts specify a la carte service to be provided by the FSMC about as often as they specify breakfast. Table 3.1 shows the percentage of FSMCs' contracts that provide for specific meal services.

[Graphic Omitted]

Assignment of Responsibility for Related Meal Service Activities Varies

The FSMC contracts vary in the assignment of eight other related meal services we reviewed. Some contracts assign responsibility for these related meal services to the FSMC, some to the food authority, and some to both organizations. Eight services we examined included (1) purchasing food, (2) counting meals, (3) inventorying and storing food, (4) planning menus, (5) providing for nutrition education, (6) cleaning, (7) paying for utilities, and (8) repairing and maintaining equipment. As table 3.2 shows, it was common for contracts to assign up to three additional meal-related services to the FSMC, while few assigned more than three of these eight services to the FSMC.

[Graphic Omitted]

Table 3.3 shows the percentage of contracts assigning responsibility for various meal services to the FSMC, the food authority, or both.

[Graphic Omitted]

In addition to these eight services, we noted that FSMCs' contracts assign responsibility for other related meal services. Some services typically assigned to the FSMC are (1) catering; (2) providing for laundry and towels, condiments, and eating utensils; (3) representing food authorities at meetings; and (4) evaluating the food service. Some responsibilities typically assigned to the food authority include providing gas

and oil for vehicles, telephone service, and garbage removal.

FSMCs' Contracts Vary in Their Treatment of Existing Personnel

Most FSMC contracts define responsibilities for managing food service personnel, but they vary in their treatment of issues affecting the employment of existing personnel. On the basis of our review of FSMCs' contracts, about 93 (86 to 99) percent of the FSMC contracts define responsibility for managing food service personnel in some fashion. More specifically, most of the contracts (82 to 97 percent) state that the FSMC will employ the food service manager. At least half (50 to 73 percent) of the contracts state that the FSMC will employ the food service staff. Other arrangements in the FSMC contracts specify that the food authority employ the staff (3 to 18 percent) and that the food authority and the FSMC each employ some of the food service staff (10 to 28 percent).

In addition, our review showed that many of the FSMC contracts (41 to 65 percent) do not mention whether currently employed school food service staff will be retained by the food authority. However, some (9 to 27 percent) contracts state that the existing school staff will retain their jobs. Table 3.4 shows the percentage of FSMCs' contracts containing language regarding the retention of existing school staff.

[Graphic Omitted]

Furthermore, FSMC contracts vary on whether they include provisions against the hiring of current FSMC employees by the food authority or the hiring of current food authority employees by the FSMC. About 50 (38 to 62) percent of the FSMC contracts contain language restricting the food authorities' hiring of FSMC personnel. Conversely, 38 (27 to 50) percent of the FSMC contracts contain restrictions regarding the FSMCs' hiring of food authority personnel.

A Vast Majority of Contracts Specify a Cost-Plus-a-Fixed-Fee Payment Structure, but Other Financial Provisions Vary

Most FSMC contracts we reviewed have a cost-plus-a-fixed-fee payment structure, but fees vary. In addition, some contracts address other financial arrangements, such as the treatment of rebates and discounts that the FSMC receives from purchasing food for the school meals programs and guarantees for a financial return or against a financial loss to the food, authority.

Most Contracts Have a Cost-Plus-a-Fixed-Fee Payment Structure, but Fees Vary

Under federal program regulations, FSMCs' contracts may specify payments to the FSMC through either a (1) cost-plus-a-fixed-fee method or a (2) fixed-price or fee payment method. On the basis of our review,

about 91 (84 to 98) percent of FSMCs' contracts use the cost-plus-a-fixed-fee payment method.

According to USDA guidance, under the cost-plus-a-fixed-fee method, the FSMC passes food service operating costs through to the food authority and charges an additional fixed- or flat-fee for management and administrative costs. Typically, the administrative fee represents overhead costs, and the management fee represents the profits. A cost-plus-a-fixed-fee payment structure may include one or more of these fees and may also be quantified as a per-meal fee and/or an annual fee. On the basis of our review, about 40 (28 to 51) percent of the FSMC contracts have only annual fees; 50 (38 to 62) percent have only per-meal fees; and 10 (3 to 18) percent have annual fees and per-meal fees. Table 3.5 shows the most common types of fixed fees and associated average dollar amounts.

[Graphic Omitted]

Although federal regulations allow another payment method - fixed price or fee payment structure – few (0.3 to 11 percent) of the FSMC contracts specify this approach. According to USDA's guidance, in a fixed-price or fee contract, charges are based on a unit charge. The unit may be per meal or per time period, typically a year. For example, the FSMC might charge $1.50 per meal, or $50,000 per year. In each instance, the fee charged is expected to cover all operating and administrative costs, and no additional costs are to be charged to the food authority.

Two other types of financial payments – cost-plus-a-percentage-of-cost and a cost-plus-a-percentage-of-income – are not permitted under federal regulations (7 C.F.R. 210.16(c)). However, one contract that we reviewed specified a cost-plus-a-percentage-of-income payment structure. We are pursuing this issue with USDA officials.

In addition to the payment structure specified in the FSMC contracts, contracts may contain language permitting the food authority and the FSMC to renegotiate payment terms. Such renegotiations could occur if actual experience does not conform to the assumptions upon which the original fee structure was based. On the basis of our review of FSMCs' contracts, about 51 (40 to 63) percent of the FSMC contracts contain provisions allowing for payment adjustments.

Treatment of Rebates and Discounts Varies

According to USDA's guidance, as a control over purchasing, the FSMC's contract should state how discounts that the FSMC obtains when purchasing food are to be passed through to the food authority.[2] We found that many contracts do not address rebates and discounts and that some FSMC contracts contain provisions allowing FSMCs to receive some of the rebates and discounts obtained from vendors. As table 3.6 shows, FSMCs' contracts vary depending on how

[2] This applies to cost-reimbursable contracts and is not applicable to fixed-price contracts.

these rebates and discounts are handled in the contracts.

Table 3.6: Treatment of Rebates and Discounts in Contracts

Contract language	Percent of FSMCs' contracts	95-percent confidence interval
Contract does not address rebates or discounts	40	28 to 51
Contract requires that all rebates/discounts be passed back to the SFA.	37	25 to 48
Contract permits the FSMC to retain some rebates/discounts obtained from vendors.	18	9 to 27

Legend

SFA = school food authority

FSMCs' contracts that permit the FSMC to retain some of the rebates/discounts also vary depending on who receives these discounts/rebates. For example, some contracts we reviewed state that only local discounts will be passed back to the food authority; other discounts or rebates, from such sources as regional and national purchasing arrangements, are to be retained by the FSMC.

Some FSMC Contracts Contain Financial Guarantees

According to USDA's guidance, FSMCs' contracts may contain language that guarantees a financial return or provides for protection against a financial loss to the food authority. On the basis of our review of FSMCs' contracts, about 18 (9 to 27) percent of the contracts contain a guarantee of surplus revenues. The average dollar amount of this guarantee was between $10,198 and $67,419. This type of guarantee was not always carried forward and in some cases was reduced when the contract was renewed. Of the 12 contracts we reviewed that initially guaranteed a surplus, 6 have contract renewals. Of those six, three continue the surplus guarantee in the current contract renewal. In two of those cases, the surplus guarantee was reduced when the contract was renewed.

In addition, on the basis of our review of FSMCs' contracts, about 44 (32 to 56) percent of FSMCs' contracts contain provisions that guarantee against a financial deficit in operating the school meals programs.

Many FSMC Contracts Do Not Contain All Eight Required Contractual Provisions That We Reviewed

USDA's guidance for food authorities' contracts with FSMCs specifies a number of provisions that must appear in the contracts to ensure that federal

requirements are met.[3] State agencies are responsible for reviewing these contracts to ensure that all the required provisions are included. We reviewed FSMCs' contracts to determine if they contained eight required provisions. We selected two provisions in each of the following four areas: (1) financial control, (2) USDA-donated foods, (3) monitoring and evaluation, and (4) duration and renewal of contracts. We found that about 57 (46 to 69) percent of the FSMC contracts do not contain all eight federally required provisions we reviewed. The required provisions that were most often not in the contracts were those intended to ensure that food authorities maintain control of the school meals programs.

Table 3.7 shows the percentage of FSMCs' contracts that do not contain one, two, three, or more of the eight federally required provisions we reviewed.

* * *

[3] See *Contracting with Food Service Management Companies: Guidance for School Food Authorities,* Food and Consumer Service, USDA (rev., Apr. 1995, final, June 1995)

USDA

U.S. Department of Agriculture
Office of Inspector General
Midwest Region
Audit Report

Food and Nutrition Service
National School Lunch Program
Food Service Management Companies

Report No.
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APRIL 2002

[SEAL]

* * *

EXECUTIVE SUMMARY

FOOD AND NUTRITION SERVICE NATIONAL SCHOOL LUNCH PROGRAM FOOD SERVICE MANAGEMENT COMPANIES

REPORT NO. 27601-0027-CH

RESULTS IN BRIEF

This report presents the results of six regional audits of the National School Lunch Program (NSLP) as operated by Food Service Management Companies nationwide. Our objective was to determine whether sufficient controls existed to ensure that management companies complied with program requirements in crediting SFA's for the value of USDA-donated commodities and purchase discounts and rebates. We

found that 5 of the 8 management companies we reviewed improperly retained benefits from 53 SFA's valued at about $6 million. This occurred, in part, because FNS' requirements and instructions were not always clear. In addition, some management companies manipulated the terms of their contracts with the SFAs in order to reduce their own costs and retain benefits that should have accrued to the SFAs. Based on the results of these audits, OIG-Investigations has opened cases on three of these management companies.

Under the NSLP, FNS provides cash reimbursements to States to provide nutritious meals to school-aged children. The States administer the program through the SFA's, which in turn contract with food service management companies to provide the food service. Food service contracts may be either fixed-rate or cost-reimbursable. In a fixed-rate contract, management companies charge a flat rate for the meals served and must credit the SFA for the full value of any USDA-donated commodities used. In a cost-reimbursable contract, management companies, as an agent of the SFA's, make purchases for and submit invoices to the SFA's for payment. In these cases, the companies must pass along any purchase discounts and rebates they receive.

We reviewed 65 SFA's served by the 8 independent management companies in 7 States nationwide. The management companies operated both fixed-rate and cost-reimbursable type contracts.

- Four of the five companies that operated under fixed-rate contracts at 46 SFA's we reviewed withheld credit for $5.8 million in USDA-donated commodities that were used in the NSLP. The management companies profited by using the USDA-donated commodities and failing to properly credit those SFA's with the commodities' value. We found that FNS did not require State agencies and their SFA's to include a specific procedure in contracts for crediting the value of the commodities to the SFA's, even though Federal regulations required that commodities solely benefit and be used in an SFA's non-profit food service operation. As a result, the USDA-donated commodities were being used to assist for-profit companies, thus decreasing the funds available to the SFA's for use in operating their food service programs. These 4 management companies operated Federal food programs at nearly 30 percent of the 1,648 SFA's nationwide that contracted with management companies in school year 1999.

- Two management companies that maintained cost-reimbursable contracts nationwide profited at the expense of 7 of the 19 SFA's we reviewed by retaining over $280,000 in discounts and rebates they received on purchases made for their food service operations. To accomplish this, the management companies amended, eliminated, or ignored terms included in the requests for proposal issued by the SFA's. Contrary to FNS regulations, the management companies were able to include contract terms that favored them, because FNS did not mandate specific contract terms and provisions. This resulted in management company contracts lacking sufficient

controls to determine exactly how the company would pass through purchase discounts and rebates in the determination of net costs. Further, the lack of FNS mandated contract provisions inhibited some States from properly addressing these requirements during reviews and development of SFA prototype contracts and bid documents. These 2 management companies contracted with over 18 percent of the 1,648 SFA's that had management company contracts nationwide.

Finally, we found that SFA's turned over most aspects of their programs, including meal accountability, to the management companies. There was little or no SFA oversight. In all, 16 of the 24 SFA's we visited did not have adequate controls in place to ensure accurate meal claims or to prevent management companies from being reimbursed for nonprogram costs. Neither the FNS Regional offices nor the States were aware that the SFA's were not providing the required oversight of management company operations. The meal accountability systems used by the SFA's resulted in inaccurate meal claims and provided the SFA's with reimbursement for 83,904 meals that were unsupported. In addition, SFA's improperly used $1.2 million in NSLP funds to reimburse three management companies for nonprogram (unallowable) costs.

KEY RECOMMENDATIONS

Each OIG region through the appropriate FNS regional office made all recommendations for the recovery of NSLP funds. However, we are recommending that FNS establish specific parameters for appropriate contract terms for States and SFA's to follow to ensure that the SFA's, not the management companies, benefit from the value of USDA-donated commodities, purchase discounts, and rebates. FNS also needs to amend regulations and guidance to reference those parameters for appropriate contract terms. In addition, we are recommending that FNS amend regulations to require each State agency to annually review and approve each contract before contract execution, and that FNS emphasize in its management evaluations a review of State and SFA oversight of management company operations.

Finally, we are recommending that States: (1) ensure that the SFA's understand that contracting with a management company does not alleviate their oversight responsibility and their need to maintain reliable meal accountability systems; and (2) require all new contracts to stipulate that, as the agents of the SFA's, management companies must comply with competitive procurement requirements for all goods and services charged, and that such charges be net of all purchase discounts and rebates are to be properly credited to SFA food service accounts and require rebid of all current contracts that do not include this requirement.

AGENCY RESPONSE

In its response to the official draft, dated April 10, 2002, FNS generally agreed with the findings and recommendations except for Recommendation No. 6, in which agency officials expressed the opinion that the recommended action was not the most effective means of addressing the cited conditions. However, FNS also stated that some of the recommended actions would require changes to the existing regulations and thus could not be implemented at this time. We have incorporated applicable portions of the FNS response, along with our position, within the Findings and Recommendations section of the report. The FNS response is included in its entirety as exhibit B of the audit report.

OIG POSITION

Based on FNS' response, we have reached management decisions on Recommendations Nos. 3, 4, 7, 8, 9, and 10. Management decisions on the remaining recommendations can be reached once FNS has provided us with the additional information outlined in the report section, *OIG POSITION*. For Recommendation No. 6, and for those recommendations which FNS officials stated could only be addressed in the long-term through regulatory changes, we requested additional

responses citing the proposed corrective actions to be taken along with their associated timeframes.

* * *

INTRODUCTION

BACKGROUND

On June 4, 1946, Congress passed the National School Lunch Act (42 U.S.C. 1751) which authorized and established the National School Lunch Program (NSLP). The purpose of the NSLP is to safeguard the health and well-being of the Nation's children and encourage the domestic consumption of agricultural commodities. The U.S. Department of Agriculture's (USDA) Food and Nutrition Service (FNS), through seven FNS Regional Offices (FNSRO), is responsible for the administration of the NSLP. The NSLP provides Federal assistance in cash and USDA-donated commodities to States in order to benefit schools' nonprofit food services.

FNS enters into written agreements with a State agency, usually a State's Educational Agency, which administers the program Statewide. The State agency is required to perform program oversight through monitoring and assisting school food authorities (SFA) in their operation of the NSLP at the local level. The SFA's are required to provide meals to children that meet certain requirements, and accurately count and claim the number of meals served to

children. FNS provides cash reimbursements to State agencies based on the monthly claims submitted by SFA's that detail the number of meals claimed as being served. In addition, FNS provides special cash assistance, through higher reimbursement rates, for reduced-price and free meals served to children determined as eligible to receive such benefits.

FNS permits SFA's to contract with food service management companies to operate their nonprofit food service operations. Although management companies can provide most of the routine administration of the food service operations, the SFA retains the responsibility of ensuring that food operations comply with program regulations. An SFA solicits bids from management companies through issuing either a request for proposal (RFP) or invitation for bid that details the contract requirements. The contract type may be either a fixed-rate-per-meal or cost-reimbursable type. In a fixed-rate-per-meal contract, management companies charge a flat rate times the number of meals claimed as being served, regardless of the costs to prepare those meals. However, in a cost-reimbursable contract, management companies, as the SFA's agent, make purchases on behalf of the SFA's and submit the invoices to the SFA's for payment.

Both types of contracts should require that certain types of benefits accrue back to the SFA. In a fixed-rate-per-meal contract, management companies are required to credit the SFA for the full value of any USDA-donated commodities that the management companies received and used in the NSLP. Under a

cost-reimbursable contract, any purchase discounts and rebates the management companies may receive, as the agent of the SFA, that would reduce the cost of goods purchased must be passed along to the SFA's, as these represent a reduction in the actual costs involved in preparing the meals.

During fiscal year 2000, FNS disbursed approximately $5.6 billion in Federal reimbursements for 4.5 billion meals claimed as being served to students, and over $800 million in USDA-donated commodities. Of the 19,329 SFA's nationwide, 1,648 of them had contracted with a management company during fiscal year 1999 to operate the NSLP/SBP in their schools. In addition, based on the data collected from the 7 FNS regional offices, they reported that there were at least 19 management companies operating an SFA's non-profit food service in 41 states.

OBJECTIVES

The objectives of this audit were to determine whether sufficient controls exist to ensure that (1) food service management companies credit SFA's for the full value of USDA-donated commodities and/or volume purchase discounts and rebate as applicable; and (2) that management companies and SFA's administered the NSLP in accordance with applicable laws, regulations, and FNS guidelines. As part of these objectives, we reviewed the FNS National Office's policies and procedures, and evaluated the FNSRO's

oversight of State agencies management companies, and SFA's to ensure their compliance. Specifically we evaluated the controls over: (1) requests for proposal (RFP) and contracts under which management companies agree to manage the SFA's' food service; (2) management companies' procedures to account for USDA-donated commodities and issue commodity credits to SFA's when fixed-rate-per-meal contracts are used; (3) procedures to ensure that volume purchase discounts, rebates, or other credits are properly accounted for by management companies and credited to the SFA's under cost-reimbursable type contracts; and (4) procedures to ensure the accuracy of meal counts, claims, and management companies' billings.

SCOPE

This nationwide audit of food service management companies' administration of the NSLP covers fiscal years 1998 through 2000 (covering the school years that operated from July 1, 1997, through June 30, 2000), but we expanded our review to earlier periods as indicated in the report. We performed our audit at the FNS National Office in Alexandria, Virginia, and six FNS Regional Offices. We judgmentally selected six States based on the highest number of management company contracts, or the highest percentage of SFA's using management companies within a State or nationwide. In addition to the six States we selected based on the above criteria, we reviewed one other

State as part of an OIG Audit and Investigative joint effort.

Within the seven States, we judgmentally selected eight management companies. Seven of these companies were selected based on the highest activity. One was selected based on information disclosed during our audit.

We visited 24 SFA's and performed a limited review of the management company contracts and other documents of an additional 41 SFA's. During fiscal years 1998 through 2000, 47 of the 65[1] SFA's we reviewed maintained fixed-rate-per-meal contracts and 19 SFA's had signed cost-reimbursable contracts with management companies. The number of fixed-rate-per-meal and cost-reimbursable contracts we reviewed does not necessarily represent the proportion of fixed-rate to cost-reimbursable nationwide.

The audit was conducted in accordance with *Government Auditing Standards* established by the Comptroller General of the United States.

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[1] One SFA in New Jersey had a fixed-rate-per-meal contract for school years 1998 and 1999 and then signed a cost-reimbursable contract with the same management company for school year 2000.

METHODOLOGY

To accomplish our audit objectives, we reviewed FNS regulations, procedures, guidelines, and memorandums issued concerning USDA-donated commodities and procurement of goods and services relevant to management companies. In addition, we interviewed officials with the Child Nutrition and Food Distribution divisions of FNS, and determined the scope of activity of management companies nationwide. Also, we reviewed the FNS regional offices' monitoring efforts of, and policy, procedures, and memorandums issued to, the State agencies relating to SFA's contracting with management companies. Through interviews of FNS Headquarters and regional office officials, we determined the scope of activity of management companies within each region and selected our States to be visited.

At the seven State agencies, we reviewed their policies, procedures, and memorandums issued to an SFA when contracting with management companies, and the SA's monitoring efforts to ensure an SFA met program requirements. Through interviews with SA officials and our review of records, we selected one management company in each state and the 24 SFA's that contracted with that management company. In addition, we selected and performed a limited review of another 41 SFA's based on the problems disclosed during our fieldwork. Furthermore, we obtained and reviewed documents relating to SFA contracting with

that management company, and the value of USDA-donated commodities received.

We reviewed the SFA's procedures for issuing RFP's and subsequent contracts with management companies to operate the nonprofit food service. We reviewed records and interviewed SFA officials to evaluate their monitoring efforts at the individual schools and procedures for ensuring the accuracy of meal claims. In addition, we reviewed records and interviewed SFA officials to ensure that; (1) for fixed-price-per-meal contracts, they received proper credit for USDA-donated commodities and they used the commodities to prepare a school lunch, and (2) for cost-reimbursable contracts, that they received applicable portions of income, rebates, and discounts, relating to any SFA's allowable cost.

When needed, we interviewed officials at each management company that was responsible for contracting and operating an SFA's school food service, and reviewed the management companies' procedures used in documenting their accounting of all applicable discounts, rebates, and allowances reviewed for purchases made on behalf of an SFA. In addition, we interviewed the management company's vendors to determine whether they paid discounts and rebates. Furthermore, we reviewed the management compa ny's procedures to submit meal claims and document their policies in contracting with vendors. However, for the management company in Illinois, we did not attempt to review their records, other than copies made available by SFA officials, or interview management

company personnel because of the ongoing investigation. The OIG Investigative staff in St. Louis, Missouri, performed interviews and reviewed original management company documents.

FINDINGS AND RECOMMENDATIONS

CHAPTER 1	MANAGEMENT COMPANIES PROFIT FROM USDA AND OTHER BENEFITS INTENDED TO SUPPORT AN SFA's NONPROFIT FOOD SERVICE

Five[2] of the eight management companies we reviewed improperly received benefits, either in the form of purchase discounts or USDA-donated commodities, which were intended to benefit the SFA's' nonprofit food services. The lack of clear instructions from FNS, in conjunction with inadequate oversight by the State agencies and SFA's, allowed the management companies to reduce their costs and retain the SFA's benefits. FNS had not required any specific contract language or procedures for State agencies and SFA's to follow to ensure that an SFA received the full benefit from USDA-donated commodities and

[2] One management company for an SFA in New Jersey retained commodity benefits under a fixed-rate-per-meal contract during school years 1998 and 1999, and retained discounts and rebates under a cost-reimbursable contract during school year 2000.

purchase discounts and rebates. In addition, we found that some management companies, when developing their responses to SFAs' Requests for Proposal (RFP), took advantage of the fact that the SFAs were not provided with explicit requirements for contract provisions. This allowed them to insert contract provisions that were contrary to Federal regulations, and which essentially allowed management companies to retain benefits that should have accrued to the SFAs' food service programs. Even where State agencies had prototype contracts that required the value of purchase discounts and USDA-donated commodities to be credited to the SFA's, there were no specific procedures governing how and when those credits were to be made. As a result, the purchase discounts and USDA-donated commodities were used to enrich the management companies instead of benefiting the SFA's as required by Federal regulations.

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agency. In addition, the guidance should specify that unapproved material deviations will require rebid of a management company contract.

Agency Response

In its response, FNS stated that they would issue a policy memorandum within 90 days of report issuance. The memorandum will notify all its regional offices to instruct their State agencies and SFA's that FSMC's must comply with the terms listed in the

RFP and that only minor deviations can be approved by a State agency.

OIG Position

We accept FNS' management decision.

FINDING NO. 2

MANAGEMENT COMPANIES FAILED TO CREDIT SFA'S FOR THE VALUE OF PURCHASE DISCOUNTS AND REBATES

Of the 19 SFA's we reviewed nationwide with cost-reimbursable contracts, 7 did not receive credit for the discounts and rebates their 2 management companies received on food purchases. The management companies were able to retain these benefits by amending, eliminating, or ignoring terms included in the RFP's issued by the SFA's that would have required them to pass through any discounts or rebates for purchases made on the SFA's behalf. Since FNS failed to mandate specific contractual terms relating to purchase discounts and rebates, the management companies were able to use contract terms that allowed them to retain the discounts and rebates. In addition, FNS did not issue clear monitoring procedures for their State agencies to follow in determining exactly how a management company should pass through the value of purchase discounts and rebates. Based on the management companies'

records, we determined that 7 SFA's paid $284,108 to reimburse the management companies for costs that they did not incur.

Departmental regulations[4] require that costs billed to an SFA under a cost-reimbursable contract are to be the actual purchase price after deducting all cash discounts, trade discounts, rebates, and allowances received. The Office of Management and Budget guidelines issued under these procurement standards[5] state that for a cost to be allowable, it must be net of all applicable credits. In addition, although not listed as a requirement, FNS Guidance for School Food Authorities – Contracting with Food Service Management Companies[6] states that an SFA's contract should incorporate controls over food purchasing and how trade discounts and rebates are to be passed through to the SFA.

We found that management companies were able to use the lack of clear procedures to retain discounts and rebates that should have been credited to the SFAs. This occurred even though FNS requires that purchase discounts and rebates must be credited to the SFA's account, since the management company is

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[4] 7 CFR Part 3015, which was subsequently replaced with 7 CFR Parts 3016 and 3019.

[5] OMB Circular A-87; Attachment A; Item C.1.i; revised May 4, 1995, as further amended August 29, 1997.

[6] Contracting with Food Service Management Companies; Guidance for School Food Authorities; dated June 1995.

an agent of the SFA and must comply with the same procurement regulations that an SFA would be required to follow. Lack of clear and specific procedures has led to confusion not only within State agencies and SFA's, but among Headquarters officials as well.

We reviewed the RFP's for 19 SFA's in 6 states that maintained cost-reimbursable contracts during school years 1998-2000 (school year July 1-June 30). All 19 SFA's, while not using the exact wording of the State's prototype RFP, used similar language regarding the handling of discounts and rebates on purchases related to the SFA's food service operations. Each of the RFP's required that the management company credit any discounts or rebates for purchases made on the SFA's behalf. However, in 2 States, Michigan and New Jersey, we found that 2 management companies benefited by retaining the value of purchase discounts and rebates.

- In the State of Michigan, we reviewed the signed contracts between 9 SFA's and the selected management companies and found that 6 of the 9 SFA's signed contracts that contained language that differed significantly from the RFP. The State agency did not identify this material charge and as a result, in each case, the contracts revised the terms of the RFP to state that the SFA was entitled to receive discounts and rebates only from local vendors. The contracts also stated that any discounts or rebates received from regional or national level vendors were to be retained by the management company. As a result of the revised contract terms, the 6 Michigan

SFA's failed to receive discounts and rebates totaling over $230,000 for school years 1998-2000. This could have been prevented had the State agency reviewed and approved the management company's contract prior to implementation.

- Even though one SFA in Michigan and one SFA in New Jersey signed contracts with their management company that required that all discounts and rebates be credited to the SFA's food service account, the SFA's still did not receive all they were entitled to. For Michigan, the management company received and retained $24,790 of the $28,177 in discounts and rebates that should have been credited to the SFA. In New Jersey, one SFA was not credited at all for 1 year's worth of discounts and rebates totaling over $47,000 in direct violation of the contract terms.

One of the two management companies was allowed to amend an SFA's contract because current FNS regulations and guidance do not contain specific requirements for contract terms. The other management company was allowed to retain discounts and rebates because FNS has not provided guidance on the method by which an SFA should ensure that it receives the discounts and rebates to which it is entitled. These two management companies alone contracted with 300 (18 percent) of the 1,648 SFA's that had management company contracts nationwide.

To assist State agencies and SFA's in contracting with management companies, FNS issued formal guidance

in June 1995. The guidance presents an overview of the Federal standards for State agencies and SFA's and highlights certain provisions as Federal requirements that must appear in the contract documents. With regards to developing a cost-reimbursable contract, the guidance states that SFA's should incorporate controls over food purchasing and explain how trade discounts and rebates are to be passed through to the SFA. However, this provision was not highlighted and was therefore not a contract requirement. In addition, FNS requires State agencies to review the management company contract but lacks regulatory authority to require States to approve a food service management company contract before implementation.

Since FNS has not issued specific language requirements, management companies were able to remove contract terms that would have required them to credit SFA's for purchase discounts and rebates. In addition, even if the contract required the management company to pass back cost reductions, FNS had not issued clear procedures on how the SFA was to ensure that it received all back discounts and rebates. The lack of specific contract language and clear procedures from FNS was compounded by an inadequate review process by the SFA's and the State agency. Furthermore, if State agencies were required to approve a management company contract prior to implementation they would have additional assurance that the RFP terms were not amended in the signed contract.

We found in our reviews of different food company contracts in seven States, that when FNS has required specific contract language (such as with the Energy Policy and Conservation Act, required by OMB A-102), specific language was included in the RFP's and signed contracts. Based on our review nationwide, FNS needs to require specific contract language regarding purchase discounts and rebates. In addition, FNS needs to strengthen its policies and procedures to ensure that SFA's receive the discounts and rebates to which they are entitled. Furthermore, FNS needs to ensure that all FNS regional offices, State agencies, and SFA's are aware of these problems we found during our audit.

RECOMMENDATION NO. 4

Amend FNS *Guidance for School Food Authorities* to identify specific contract terms that a State agency and SFA must use to ensure that management companies, as agents of the SFA's, comply with all applicable competitive procurement procedures that should result in net costs being charged to an SFA so that the SFA, and not the management company, receives the benefit of cost reductions in the form of discounts, rebates, and allowances. (One of the required terms for cost-reimbursable contracts must state that all costs charged to the SFA must be net of all discounts, rebates, and allowances received by a management company, and that this cost reduction shall be shown on the monthly invoice or operating

statement as a credit or reduction to the amount billed.)

Agency Response

FNS agreed with this recommendation and stated it will amend and issue, by March 2003, a revised guidance for SFA's to help ensure that FSMC's comply with all applicable competitive procurement procedures that should result in net costs being charged to an SFA.

OIG Position

We accept FNS' management decision.

RECOMMENDATION NO. 5

Amend FNS regulations to require that State agencies include language in their RFP prototypes that require contract review by State officials prior to the SFA signing and implementing a management company contract.

Agency Response

In its response, FNS stated that its response depended on the outcome of suggestions from a group of State agency officials on the best way to ensure that procurement and contract activities comply with Federal requirements.

OIG Position

To reach management decision, FNS needs to provide us with a further response specifying its proposed corrective actions and the planned timeframes for their implementation.

RECOMMENDATION NO. 6

Amend FNS regulations and *Guidance for State Agencies* to require each State agency to annually review and approve each contract between any SFA and management company to ensure compliance with all the provisions and standards set forth in 7 CFR 210.16, before contract execution.

Agency Response

In its response, FNS stated that it disagreed that the action required by this recommendation would be the most effective means to ensure compliance with 7 CFR 210.16. FNS stated that it will solicit responses from a group of State agency officials on the best way to ensure that procurement and contract activities comply with Federal requirements.

OIG Position

To reach management decision, FNS needs to provide us with its alternate proposals and the timeframes when a final recommendation would be made.

RECOMMENDATION NO. 7

Notify all FNS regional offices to inform their State agencies that all new contracts must require that only costs net of all discounts or rebates are allowable costs to be charged to the SFA's nonprofit food service account and any current contracts that do not contain this requirement must be rebid as soon as possible.

Agency Response

In its response, FNS agreed to issue guidance, within 90 days of report issuance, to all its regional offices to inform State agencies of this requirement.

OIG Position

We accept FNS' management decision.

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EXHIBIT A - NATIONWIDE SUMMARY OF SITES SELECTED

OIG REGION	STATES SELECTED	NUMBER OF MANAGEMENT COMPANIES REVIEWED	NUMBER OF SFA's REVIEWED	NUMBER OF FIXED-RATE CONTRACTS	NUMBER OF COST-REIMBURSABLE CONTRACTS
Northeast	New Jersey	1	1[12]	1	1
Southeast	South Carolina	1	3	1	2
Midwest	Illinois	1	8	8	-
	Michigan	1	9	-	9
Great Plains	Missouri	1	37	36	1
Southwest	New Mexico	2	6	1	5
Western	Washington	1	1	-	1
TOTALS		8	65	47	19

[12] The same SFA and management company signed a fixed-rate contract for school years 1998 and 1999, then signed a cost-reimbursable contract for school year 2000.

TESTIMONY OF PHYLLIS K. FONG

INSPECTOR GENERAL
OFFICE OF INSPECTOR GENERAL
U.S. DEPARTMENT OF AGRICULTURE

Before the

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON THE BUDGET

ON

FRAUD, WASTE, AND ABUSE
IN MANDATORY SPENDING PROGRAMS

JULY 9, 2003

Thank you, Mr. Chairman and members of the committee. I am pleased to be here to provide testimony about the Office of Inspector General's (OIG) perspective on fraud, waste, and abuse in mandatory programs administered by the U.S. Department of Agriculture (USDA).

BACKGROUND

USDA's Office of Inspector General has over forty years of service within the Department and as such has a long history of identifying fraud, waste and abuse in USDA's programs. Although our tools and techniques have changed over the years, our purpose remains the same: to perform audits and investigations of the Department's more than 300 programs and operations, recommend policies and actions to promote economy and efficiency,-and prevent and detect fraud, waste, and abuse in

* * *

Another area in the National School Lunch and Breakfast Programs prone to fraud, waste, or abuse involves local school food authority contracts with food service providers. OIG is working with FNS to address cost reductions in the form of contract discounts, rebates, and allowances. Federal cost principals require that such benefits accrue to the program. However, the Office of Management and Budget has recently determined that Federal cost principles do not apply to local contracts with food service management companies. FNS is pursuing regulatory action to address this problem. Our investigations have also identified schemes by food service providers to inflate expense claims. One large food service provider agreed to pay $325,000, in order to settle a lawsuit brought in regards to inflated National School Lunch Program claims. In its billings to several school districts, this firm inflated flat rate labor costs for employee-related expenses and claimed for insurance expenses that had not been incurred.

* * *

USDA report Contractors skimmed millions from lax education clients

Paul King

WASHINGTON – Six contract companies that manage hundreds of school foodservice operations were able to skim millions of dollars in cash or commodities from their clients, in part because of lax oversight by district administrators, the Agriculture Department's inspector general said in a newly released report.

The investigations unit of the USDA's Office of the Inspector General has "opened cases" on three of the six foodservice management companies whose client school districts were audited by the OIG. In all, eight companies' contracts were reviewed.

At presstime the government had identified none of the contractors or school districts, and efforts to determine their identities were unsuccessful.

The GIG [sic], as part of its report, made a number of recommendations to the USDA for improving oversight and accountability in the National School Lunch Programs. The audits involved only schools that receive commodities and reimbursements from the government for participating in the NSLP.

Despite the report's absence of identifications, it stated that the six companies cited in the audit operated federal food programs at nearly 50 percent

of the 1,648 school foodservice authorities nationwide that outsourced their food programs as of 1999.

Questions about the audit were referred to Stephen W. Fowkes, director of the Food and Marketing Division of the OIG. Fowkes, however, was not available for comment.

"ASFSA will not comment on the report," said Barry Sackin, director of government affairs for the American School Food Service Association.

The GIG [sic] audited 65 school foodservice authorities in seven states. A majority of the SFAs, 37, were in Missouri. The other states were Illinois, Michigan, New Jersey, New Mexico, South Carolina and Washington.

"Our objective was to determine whether sufficient controls existed to ensure that management companies complied with program requirements in crediting SFAs for the value of USDA-donated commodities and purchase discounts and rebates," the report stated.

"We found that five of the eight management companies improperly retained benefits from 53 SFAs valued at about $6 million," the reported added. "In addition, some management companies manipulated the terms of their contracts with the SFAs in order to reduce their own costs and retain benefits that should have accrued to the SFAs."

The companies in the audit operated under two types of contracts, fixed-rate and cost-reimbursable. In

fixed-rate contracts the companies charge a flat fee for meals served and must credit the school district for the full value of any USDA-donated commodities. In cost-reimbursable contracts, companies act as agents for the school districts, making necessary purchases and billing the districts for the items. Under such contracts the companies are required to pass along any purchase discounts and rebates they receive.

Among the companies in the audit, five had fixed-rate contracts, and three had cost-reimbursable arrangements.

In its investigation, the GIG [sic] found that four companies with fixed-rate deals used $5.8 million worth of USDA commodities and did not credit the SEAs [sic] for the value of the commodities.

"As a result," the report stated, "commodities were being used to assist for-profit companies, thus decreasing the funds available to the SFAs for use in operating their foodservice programs."

Among the three companies that operate under cost-reimbursable contracts, two "profited at the expense of seven of the 19 SFAs we reviewed by retaining over $280,000 in discounts and rebates they received on purchases made for their foodservice operations."

The school districts themselves did not escape the audit unscathed, nor did the USDA. The GIG [sic] chastised eight school foodservice authorities for

exercising little or no oversight of the contracts they had awarded.

"In all, 16 of the 24 SFAs we visited did have adequate controls in place to ensure accurate meal claims or to prevent management companies from being reimbursed for nonprogram costs," the report stated.

For example, the GIG [sic] said, meal accountability systems used by the SFAs provided them with reimbursement for thousands of meals that were not supported by the data audited. In addition, SFAs reimbursed three of the contract companies for nonprogram costs, to the tune of $1.2 million in money from the NSLP.

"Contracting with a management company does not alleviate [school authorities'] oversight responsibility and their need to maintain reliable meal accountability systems," the auditors stated. They recommended that state agencies take steps to make sure school districts understand that and suggested that states require all foodservice contracts to state clearly contractors' obligation to credit SFAs for commodity purchases, purchase discounts and rebates.

The report also chided the Food and Nutrition Services division of the USDA, saying that FNS rules were not specific enough to prevent management companies from including contract terms that benefit them.

The auditors recommended that ENS [sic] authorities amend their regulations regarding the outsourcing of school foodservice to close loopholes being used by contractors. They also urged the FNS to require states to review and approve school foodservice contracts on an annual basis.

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